Supreme Court, U. S.
FILED
FEB 17 1977
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-1137

ARTHUR FULMAN, ET AL., TRUSTEES,
PETITIONER,

v.

UNITED STATES OF AMERICA,
RESPONDENT.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

DANIEL D. LEVENSON
JONATHAN J. MARGOLIS
LESLIE CRANE SLAVIN
Attorneys for Petitioner

LOURIE & CUTLER
One State Street
Boston, Massachusetts

Blanchard Press, Inc., Boston, Mass. — Law Printers

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UNITED STATES OF AMERICA,
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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

Petitioners, Arthur Fulman et al., Trustees, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the First Circuit entered in this proceeding on November 19, 1976.

Opinions Below

The opinion of the Court of Appeals appears in Appendix A hereto. The opinion of the United States District Court for the District of Massachusetts is reported at 407 F. Supp. 1039, and a copy thereof is included in Appendix B.

Jurisdiction

The judgment of the Court of Appeals for the First Circuit was entered on November 19, 1976, and this petition for certiorari is filed within 90 days of that date. This Court's jurisdiction is invoked under 28 U.S.C. section 1254(1).

Question Presented

Whether, in determining the amount of a deficiency dividend for the purpose of calculating the undistributed personal holding company income of a personal holding company under section 545 of the Internal Revenue Code of 1954, the value of property distributed to individual stockholders should properly be taken into account at its fair market value, as Petitioner contends, or at its adjusted basis to the corporation, as Respondent contends.

Statutory Provisions Involved

Pursuant to Rule 23(1)(d), the full text of the relevant portions of the following statutory provisions are recited in Appendix C.

Sec. 541 — Imposition of Personal Holding Company Tax.
Sec. 545 — Undistributed Personal Holding Company Income.
Sec. 547 — Deduction for Deficiency Dividends.
Sec. 561 — Definition of Deduction for Dividends Paid.
Sec. 562 — Rules Applicable in Determining Dividends Eligible for Dividends Paid Deduction.
Sec. 316 — Dividend Defined.
Sec. 301 — Distribution of Property.

Statement of the Case

This is a tax refund suit involving the application of sections 541, 545, 547, 561 and 562, of the Internal Revenue Code of 1954, as amended, which impose a penalty tax on corporations which satisfy the criteria for classification as a personal holding company, and of sections 316 and 301 of said Code which affect the taxation to shareholders of corporate distributions. The tax is imposed on the undistributed personal holding company income of a corporation, which represents the taxable income as determined for corporate income tax purposes adjusted as specified in section 545. One of those adjustments is the deduction for dividends paid, including "deficiency dividends" declared and paid in a subsequent taxable year. The definition of a dividend paid for the purpose of the calculation of undistributed personal holding company income (and also for the purpose of calculating accumulated taxable income under sections 531-537) is to be found in section 561.

Petitioner filed the instant civil action in the United States District Court for the District of Massachusetts on the ground that personal holding company taxes and interest were erroneously and illegally assessed against and collected from it for its taxable years ended December 31, 1962 and December 31, 1963. Jurisdiction of that Court was invoked under 28 U.S.C., section 1346(a)(1).

Petitioners (hereinafter referred to as Taxpayer) are the successors in interest to the Pierce Investment Company, a Massachusetts corporation, which is now liquidated.

Taxpayer was determined to be a personal holding company for its taxable years ended December 31, 1962 and 1963. Pursuant to the provisions of section 547, the taxpayer distributed to its shareholders certain marketable securities as "deficiency dividends" and then filed a claim under section 547(e), valuing the distributed securities at

their fair market value, and thereby offsetting all undistributed personal holding company income for both taxable years. Respondent denied a deficiency dividend deduction for the fair market value of the securities distributed, asserting that the valuation for those purposes should only be the adjusted basis of those securities, pursuant to the provisions of Treas. Reg. 1.562-1(a). The personal holding company tax was imposed upon the difference between the adjusted basis and the fair market value of the distributed securities, that difference having been determined to be undistributed personal holding company income.

The facts were not disputed by the parties. A stipulation was entered into in the District Court for the purpose of determining the issue of the legality of Treas. Reg. 1.562-1(a). Taxpayer concedes that if Treas. Reg. 1.562-1(a) is valid, then the personal holding company tax was properly imposed upon the excess of the market value of the securities on the dates of distribution over their adjusted bases.

Both the District Court and the First Circuit upheld the validity of Treas. Reg. 1.562-1(a), for slightly different reasons.

Reasons for Granting the Writ

I. The Decision of the First Circuit Directly Conflicts With the Decision of the Sixth Circuit in *H. Wetter Manufacturing Co.* v. *U. S.*, 458 F.2d 1033 (6th Cir., 1972).

In the *Wetter* case the Sixth Circuit held that Treas. Reg. 1.562-1(a) was invalid because its content exceeded the authority granted to the Secretary of the Treasury, or his delegate, to issue regulations for the enforcement of the Internal Revenue Code. Rather, the Sixth Circuit found that the statutory pattern was clear, that said regulation conflicted with the Code, and that the property distributed to individual shareholders should be valued at its fair market value on the date of distribution. The material facts were the same in the *Wetter* case as they are in the instant case, except as to the amount of undistributed personal holding company income involved.

Further, the same issue, substantially on identical facts, has been raised in the case of *Gulf Inland Corporation* v. *U. S.* (U.S.D.C., La. 1975); on appeal to the Fifth Circuit (the case has been briefed by both parties but oral argument has not been made at this time). The District Court relied on the *Wetter* case, and thereby denied the validity of Treas. Reg. 1.562-1(a).

Taxpayer has no knowledge of other pending cases raising the same issue, and has no practical way to ascertain whether such cases are presently docketed in the District Courts, Court of Claims, or are pending before the Internal Revenue Service.

It is unfair that a different legal rule should exist in the Sixth Circuit than in the First Circuit as to taxpayers similarly situated.

II. This Same Issue Will Continue To Be Litigated Until Resolved by This Court.

The Internal Revenue Service has designated the issue involved in this case as a "prime issue", meaning that it is an issue which presents a "legal question of major importance in the administration of the internal revenue laws and which have not been tested adequately in litigation." MT 1200-143 (11/19/74) IR Manual.

The regulation affects not only the calculation of undistributed personal holding company income but also the calculation of taxable income for the purpose of determining the accumulated earnings tax, section 531 *et seq.*, Internal Revenue Code of 1954. Thus, the resolution of this dispute has applicability beyond the rather narrow scope of the personal holding company tax.

Based upon the current litigating policy of the Internal Revenue Service, the issue will continue to be litigated. The material facts will necessarily be the same in whatever forums the cases are brought, namely that property has been distributed with a value on the date of distribution which varies from its adjusted basis.

Taxpayer respectfully submits that the prospect of continued and needless litigation and the resultant uncertainty in the administration of both the personal holding company tax law and the accumulated earnings tax law justifies the grant of certiorari to review the judgment below, and resolve the issue.

III. Treas. Reg. 1.562-1(a) Represents a Dangerous Extension of the Regulation-making Power of the Secretary of the Treasury.

In none of the decided cases, *Wetter*, *Fulman*, or *Gulf Inland*, has the government successfully contended that its position in Treas. Reg. 1.562-1(a) is *supported* by statute. Rather, the Government has contended that no statute *prohibits* the result achieved by that Regulation, and that the Committee Reports on the Internal Revenue Code of 1954, both of the House and Senate, indicate that such a result was intended. Therefore, the Government justifies said regulation by reference to a Committee Report even though no statute remotely authorizes the result.

In the *Wetter* case, the Sixth Circuit found that the statutes were clear and that reference to the Committee Reports was barred, stating:

> "Like other extrinsic aids to construction, the use of legislative history is to *solve*, but not to *create* an ambiguity."

To the contrary, the First Circuit has not found the statutory pattern to be clear, and has resorted to the Committee Reports, not for interpretation of a statute, but to justify a regulation for which the First Circuit acknowledges there is no direct statutory authority. Taxpayer submits that the Government has no authority to promulgate a Regulation of major importance in the administration of the Internal Revenue Code without the mandate of the Code section under which it is to be issued.

Conclusion

For the reasons stated above, a writ of certiorari should issue to review the judgment and opinion of the First Circuit.

Respectfully submitted,

Daniel D. Levenson
Jonathan J. Margolis
Leslie Crane Slavin
Attorneys for Petitioner

Lourie & Cutler
One State Street
Boston, Massachusetts

APPENDIX A

United States Court of Appeals
For the First Circuit

No. 76-1165

ARTHUR S. FULMAN, ET AL.,
PLAINTIFFS, APPELLANTS,
v.
UNITED STATES OF AMERICA,
DEFENDANT, APPELLEE.

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF MASSACHUSETTS

Before COFFIN, *Chief Judge*,
CLARK,* *Associate Justice*, U.S. Supreme Court (Ret.),
and CAMPBELL, *Circuit Judge*.

Daniel D. Levenson, with whom *Jonathan J. Margolis*, *Mary Gallagher*, and *Lourie & Cutler* were on brief, for appellants.

Gary R. Allen, Attorney, Tax Division, Department of Justice, with whom *Scott P. Crampton*, Assistant Attorney General, *James N. Gabriel*, United States Attorney, *Gilbert E. Andrews*, and *Alfred S. Lombardi*, Attorneys, Tax Division, Department of Justice, were on brief, for appellee.

November 19, 1976

COFFIN, *Chief Judge*. The sole issue in this appeal is the validity of the Treasury regulation which provides that the amount of a personal holding company's deduction for a dividend in kind is the company's adjusted basis in the property. Appellants contend that this regulation is invalid

* Sitting by designation.

because the only permissible interpretation of the relevant provisions of the Internal Revenue Code is that the amount of such a deduction must be the fair market value of the property that is distributed. The district court sustained the validity of the regulation. We affirm.

The tax on personal holding companies, 26 U.S.C. §§ 541-47 (hereinafter "26 U.S.C." will be omitted from all statutory citations), is one of several devices Congress has developed to prevent individuals from taking advantage of the fact that the maximum income tax rate is substantially lower for corporations than it is for individuals. To discourage individuals with substantial investment income from incorporating their "pocketbooks", thereby avoiding taxation of that income at the higher individual tax rates, the Congress imposed a penalty tax on the undistributed income of those corporations which it determines are probably operating for tax avoidance objectives. The Code defines a corporation as a "personal holding company" for a given tax year if 60 per cent or more of its stock is owned, actually or constructively, by five or fewer individuals and if 60 per cent or more of its adjusted gross income is "personal holding company income", which is defined in § 543 as primarily passive investment income. *See* § 542. The Code imposes a 70 per cent tax on the company's "undistributed personal holding company income", its taxable income with specified adjustments. *See* §§ 541, 545(a). One such adjustment to the corporation's taxable income is a deduction for dividends that are paid. The issue in this case concerns the proper method to value such dividends.

Appellants are the successors of the Pierce Investment Company (Company), a taxpayer which the Internal Revenue Service (IRS) found to be a personal holding company for the tax years 1959 through 1963 and for which the IRS proposed a personal holding company tax of $26,571.30. In an attempt to eliminate this tax, the Company declared a

dividend in the amount of $32,535 and tried to satisfy its declaration by distributing stock which had a fair market value of that amount, but in which the Company had an adjusted basis of $18,725.11.[1] The IRS subsequently disallowed the Company's claim for a deficiency dividend of $32,535 to the extent that the amount claimed exceeded the Company's adjusted basis in the property that was distributed. In taking this action, the IRS relied upon the Treasury Regulation on Income Tax, § 1.562-1(a), which provides as follows:

> "If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution."

The Company paid the resulting deficiencies in full, and appellants instituted this action for a refund in district court, claiming that the regulation in question is invalid.

In considering appellants' attack on this regulation, we begin by observing that Treasury regulations are entitled to deference. "As 'contemporaneous constructions [of the Internal Revenue Code] by those charged with administration of' [it], the Regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes,' and should not be overruled except for weighty reasons." *Bingler* v. *Johnson,* 394 U.S. 741, 749-50 (1969) *quoting from Commissioner* v. *South Texas Lumber Co.,* 333 U.S. 496, 501 (1948). *See also United States* v. *Correll,* 389 U.S. 299 (1967). Although the one other circuit court of appeals that has considered this issue has concluded that the

[1] Although the relevant tax years had ended, § 547 and § 563 authorized the Company to reduce or eliminate its personal holding company tax by making an agreement with the IRS concerning the amount of its tax liability and then making a "deficiency dividend distribution" within 90 days of the agreement.

regulation is invalid, *see H. Wetter Mfg. Co.* v. *United States,* 458 F.2d 1033 (6th Cir. 1972), we are satisfied that the regulation is a reasonable interpretation of the revenue statutes and, as such, is valid.

We note at the outset that this regulation, which was adopted under the Internal Revenue Code of 1954, substantially reflects the rule which has been established by statute prior to 1954, but which had not been expressly reenacted in 1954. Section 27(d) of the Internal Revenue Code of 1939 expressly provided that the amount of a deduction for dividends paid in kind was either the corporation's adjusted basis in the property or the fair market value thereof, whichever was less. Here, the issue is whether Congress, by failing to include old § 27(d) in the 1954 revision of the Internal Revenue Code, intended both to preclude the Treasury Department from adopting a regulation which generally embodied the terms of the pre-1954 law, and to prescribe that it instead adopt a rule valuing the deduction for dividends paid in kind on a fair market value basis. We see no evidence that Congress intended such a result. Indeed, what evidence there is supports the validity of the regulation. Moreover, we think that the rule based upon old § 27(d) is entirely consistent with the broad objectives of the personal holding company tax, and that the contrary rule would both defeat the underlying policy of the act and produce results which would be difficult to justify rationally.

Although the 1954 Code, which has not been amended in any respect which is significant to this case, did not prescribe the method of valuing a dividends paid deduction, the legislative history of the 1954 Code indicates that Congress contemplated that the rule of old § 27(d) was to be carried over into the 1954 revision. The Senate Finance Committee Report on § 562(a) stated as follows:

> "Subsection (a) provides that the term 'dividend' for purposes of this part shall include, except as other-

wise provided in this section, only those dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions). *The requirements of sections 27(d), (e), (f), and (i) of existing law are contained in the definition of "dividend" in section 312 and accordingly are not restated in section 562."* [Emphasis supplied.] S. Rep. No. 162, 83d Cong., 2d Sess., 3 U.S.C. Cong. & Adm. News 4621, 4965-66 (1954).

See also H. Rep. No. 1337, 3 U.S.C. Cong. & Adm. News 4017, 4320 (1954). Although the language of this report is ambiguous in several respects and may not support the government's claim that it indicates that § 312 is to govern such matters,[2] this report certainly indicates that Congress did not contemplate the abrogation of the rule of old § 27(d).

And there is nothing in the Code which suggests that Congress in fact intended that the deduction for dividends paid in kind be based on the fair market value of the property. Indeed, to the extent that there is anything relevant in the Code, it appears to be consistent with the regulation that is under attack. Section 561, which defines the deduction, and §§ 562 and 316, which determine which distri-

[2] Although the United States argues that this legislative history clearly indicates that Congress intended that § 312—which, as we note, is consistent with, but does not compel, the rule under attack—would determine the amount of a dividends paid deduction, the committee report is ambiguous. The italicized sentence's description of § 312 as "defining" the term dividend apparently refers to the role that § 312 played in the House version of the bill. The House § 312 was amended by the Senate and became § 316, which, as we will indicate, does not deal with the issue at hand. Although we note that a comparison of Code § 312 with the sections of the 1939 Code referred to in the italicized sentence suggests that the Senate Report may have had Code § 312 in mind, we cannot eliminate the inference that the reference to § 312 may have simply been a typographical error. Therefore, we do not rely upon this legislative history for the proposition the government urges.

butions qualify for it, are silent[3] as to the valuation of the personal holding company's deduction.[4] The only provisions of the Code which offer any guidance on this question do not appear to be directly relevant, but they seem generally supportive of the validity of the regulation and in no way suggest that the rule embodied therein is inconsistent with the statutory scheme.

Section 312 is the only provision of the Code which, to our knowledge, deals specifically with the effect of a corporate distribution on the distributing corporation. It provides that a dividend that is paid in property will have the effect of decreasing a corporation's earnings and profits by the amount of the corporation's adjusted basis in the property. Although we understand that the payment of a dividend by an ordinary corporation does not give rise to a corporate deduction, and that this section, in its normal operation, only determines the tax effects of present and future corporate distributions on the corporation's shareholders, *see* Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 7.24, we think this

[3] Even if other provisions in the Code support the regulation, appellants urge that we must hold it invalid because § 562, under which it was issued, does not directly support the regulation. This argument is strained. Since § 562 specifically deals with the subject of the dividends paid deduction—which applies to provisions other than the personal holding company tax—one would expect to find the rules governing its use in the regulations promulgated under § 562. If the regulation in question is consistent with the terms and policy of the revenue act—which it is—we do not believe it is rendered invalid because the specific statutory support for it is arguably found not in § 562 but elsewhere in the Code.

[4] Section 561 is purely definitional. Section 562 deals with several aspects of the problem of eligibility for the deduction, but refers to § 316 for the definition of dividend. Section 316, in turn, provides that a distribution is a dividend to the extent of a corporation's "earnings and profits", § 316(a), and that a distribution in property by a personal holding company will be a dividend to the extent of the company's "undistributed personal holding company's income". § 316(b).

section strongly suggests that Congress believed that, as far as the distributing corporation is concerned, the amount of a dividend in kind is the corporation's basis in the property. Certainly § 312 rebuts any contention that, as to the distributing corporation, the "plain meaning" of the term "dividend" is that it is equal to the fair market value of any property that is distributed, *but see H. Wetter Mfg. Co.* v. *United States, supra,*[5] or that Congress clearly manifested an intention to abrogate the rule of old § 27(d).[6]

The second provision of the Code — which appellants rely upon — is § 301, which defines the tax consequences of a corporate distribution on the recipient thereof. It provides "the amount distributed" to a recipient is the fair market value of the property received, in the case of a noncorporate distrubutee, or the distributing corporation's adjusted basis of the property (plus any gain that is recognized to the distributing corporation) in the case of a corporate distributee. To the extent that the distribution

[5] In concluding that the regulation under attack is invalid, the *Wetter* court reasoned that § 301, which determines the effect of a corporate distribution on a recipient, established that the "plain meaning" of § 562's reference to dividend is that such dividends are valued on a fair market value basis, and that, given the "plain meaning" of the statute, it would be improper to consider any other aids to its interpretation. *See H. Wetter Mfg. Co.* v. *United States, supra,* 458 F.2d at 1035-36. Although we doubt that we would have refused to consider the legislative history and objectives of the personal holding company tax even if we agreed with this approach to § 562, § 312 persuades us that § 562 has no such "plain meaning". Our consideration of the legislative history and purposes of the provisions in question compel the conclusion that the regulation is valid.

[6] Indeed, it is possible to read § 312 and § 316(b) as prescribing the rule in the regulation under attack. Section 316(b) suggests that, as to distributions in property by personal holding companies, the term "undistributed personal holding company income" may be substituted for "earnings and profits" wherever the latter appears in the Code. If § 316(b) were conceived of as having this implication, § 312 would announce the rule contained in the regulation.

qualifies as a dividend under § 316, the amount distributed will be ordinary income to the recipients. *See* § 61. Although § 301 is one of the few places in the Code where the phrase "amount distributed" appears, we can see no reason to treat it as establishing the rules for determining the amount of a personal holding company's dividends paid deduction. It, of course, deals only with the effect of a distribution on the recipients, and is thus less relevant than § 312. Moreover, were § 301 determinative, the amount of a corporation's dividends paid deduction would depend upon the character of the recipient, an anomaly which we strongly doubt Congress could have intended.

Although the evidence is that Congress clearly did not intend to abrogate the rule of old § 27(d) and probably intended to carry it over substantially, the consideration we ultimately find most persuasive is that appellants' approach would significantly undercut the effectiveness of the personal holding company provisions and would produce results which, in our view, would be irrational in light of the objectives and structure of this tax. The personal holding company tax, as we have noted, was enacted to combat the tax avoidance that could result from the accumulation of income from passive investment activity in a closely held corporation. It operates to force both the distribution of such earnings and the realization of dividend income at the shareholder level by imposing a penalty tax on the undistributed *income* which had been *realized* by such corporations during given tax years. Appellants' proposed approach would permit a corporation, which had distributed property representing substantially unrealized appreciation, to continue to accumulate the income it had realized on its investments during the relevant tax year — without being under any compulsion to distribute such earnings. The net effect would be that the corporation, and hence the shareholders, could succeed in shielding passive invest-

ment income from the operations of the personal holding company tax, contrary to the clear intent of these provisions.[7] By basing the deduction for dividends paid on the amount of the corporation's investment in the property distributed, the regulation prevents any such income shielding.[8]

Appellants' approach, moreover, would produce results which we would find impossible to square with the structure and operation of this tax. Whether a corporation is a personal holding company and the amount of its personal holding company tax liability depends upon the amount and nature of the corporation's income during a given tax year. Under appellants' proposal, personal holding companies,

[7] Appellants claim that the policy of the personal holding company tax compels the acceptance of their claim that § 301 should be determinative of the amount of any deduction. They trace the history of this tax and assert that the objective of these provisions has always been to compel corporate distributions which will result in ordinary income to the shareholders of an amount that is equal to, but not greater than, the corporation's "undistributed personal holding company income" prior to the distribution. It follows, they insist, that the amount of a dividends paid deduction should be equal to the amount of income that will be recognized at the shareholder level—that is, when, as here, the recipients are individuals, the fair market value of the property. The short answer to this argument is that § 27(d) of the 1939 Code plainly adopted a contrary policy; it simply is not the case that the policy has "always been" as they assert. More significantly, our analysis of the 1954 revision of the Code has persuaded us that Congress did not intend to abandon the policy embodied in old § 27(d).

[8] Appellants note that the regulation under attack has the same effect as a rule which provides that a corporation realizes a gain whenever it distributes appreciated property and then permits a deduction based on the fair market value of the property. This result, they suggest, is contrary to the policy of § 311, which provides that a corporation that distributes appreciated property only recognizes a gain in special circumstances, none of which are present in the case at bar. The short answer to this argument is that § 311 states the rule for ordinary corporate distributions, which do not give rise to corporate deductions. That corporate distributions which give rise to deductions should be treated differently is required by the objectives of this tax.

which had identical amounts of taxable income and which had invested identical amounts in the assets which produce their respective incomes, could have completely different tax liabilities after distributing assets representing the same level of corporate investment. The disparate treatment would not arise from any differences in their tax situation during the tax year in question, but from the fact that the assets which they had distributed had appreciated at different rates during the period prior to that tax year.

Since we think the regulation in question is entirely consistent with the objectives and terms of the revenue act, we hold that the district court was correct in sustaining the validity of this regulation against appellants' attack and in rejecting appellants' claim for a refund.

Affirmed.

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

Civil Action No. 73-1109-M

ARTHUR S. FULMAN ET AL.,
PLAINTIFFS,
v.
UNITED STATES OF AMERICA,
DEFENDANT.

MEMORANDUM and ORDER

MURRAY, D.J. This case came on to be considered on the respective motions of plaintiffs and defendant for summary judgment, the parties having stipulated all material facts and waived oral argument. The sole issue may be stated as follows:

> For purpose of computing the deduction provided by Section 545 of the Internal Revenue Code (Code) of 1954 (the deduction for dividends paid under the personal holding company tax), is a dividend paid by a holding company with the securities of other corporations to be valued to the holding company at the company's adjusted basis of the securities or at their fair market value at the time of distribution?

This same issue was considered in *H. Wetter Manufacturing Co.* v. *United States*, 458 F.2d 1033 (6th Cir. 1972). There the court undertook to journey through the Code seeking resolution of the issue in the following language:

> In determining how Congress wished the deduction to be computed, we start with Section 545 of the Code. This section provides that the undistributed personal holding company income is the taxable income of the personal holding company adjusted as allowed by law

> and minus ". . . the dividends paid deduction as defined in section 561." Section 561 provides that the rules provided in section 562 and 563 shall be applicable in determining the deduction for dividends paid. Section 562 provides that ". . . the term 'dividend' shall, except as otherwise provided in this section, include only dividends described in section 316 . . ." Section 316 provides that if the distributing corporation is a personal holding company during the year in which the distribution is made, ". . . the term 'dividend' also means any distribution of property . . . made by the corporation to its shareholders, to the extent of its undistributed personal holding company income . . . for such year."

Id. at 1034.

After considering the contentions and briefs of the parties, the court agrees with, and adopts, the quoted language as relevant to the issue here. However, the court is not persuaded to follow *Wetter* beyond the quoted language, particularly where it referred to section 301(d)(1), seemingly as bearing upon the computation of the dividends deduction in the hands of the distributing personal holding company, and rejected the Treasury Regulation 26 C.F.R. § 1.562-1(a) as inconsistent with the Code. The court agrees with *Wetter* that "[a] Court may not enforce a regulation which is plainly inconsistent with the revenue statute" (*id.* at 1035), but, with respect, disagrees that the "plain meaning" rule of statutory construction resolves the issue. *Cf.* D. Kahn, Basic Corporate Taxation 195 (1973); 51 Tex. L. Rev. 368 (1973).

From a consideration of the arguments of the parties and analysis of the pertinent provisions of the Code, the court reaches the following conclusions:

(1) Section 301 of the Code does not unambiguously support plaintiffs' contention that valuation at fair market

value of the dividend is the proper construction of section 562 of the Code in resolving the issue here. Considered together, sections 301 and 316[1] are not clearly dispositive of the issue. Section 301(d)[2] speaks only of the valuation of a corporate dividend received by a shareholder-distributee; it does not by its terms purport to govern the effect of the distribution on the corporate-distributor of property distributed as a dividend. Accordingly, the court respectfully declines to follow the holdings of *Wetter* and *Gulf Inland Corp.* v. *United States,* 36 AFTR 2d 75-5511 (W.D. La. 1975).

(2) Section 312 of the Code does not establish a yardstick of valuation for determining the amount of dividends paid deduction by a personal holding company at the company's adjusted basis in the property distributed, as defendant contends. Section 312 provides for valuation of a distribution as a dividend only in relation to a corpo-

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[1] 26 U.S.C. § 316, in pertinent part, provides:

(a) . . . To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

[2] 26 U.S.C. § 301, in pertinent part, provides:

(d) *Basis.*—The basis of property received in a distribution to which subsection (a) applies shall be—

(1) *Noncorporate distributees.*—If the shareholder is not a corporation, the fair market value of such property.

(2) *Corporate distributees.*—If the shareholder is a corporation, whichever of the following is the lesser:

(A) the fair market value of such property; or

(B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property, increased in the amount of gain to the distributing corporation which is recognized under subsection (b) or (c) of section 311, under section 341(f), or under section 617(d)(7), 1245(a) or 1250(a).

ration's earnings and profits. Section 316(b)(2)(A), however, contemplates that a distribution by a personal holding company may be treated as a dividend even if it is in excess of the corporation's earnings and profits. *See* B. Bittker & J. Eustice, Federal Income Taxation of Corporations ¶ 8.25 n.102 (3rd ed. 1971).

(3) Where the statutory provisions relied upon by the parties do not unambiguously support their respective contentions as to the construction of section 562 of the *Code* in determining the basis for computing the dividends paid deduction, the court may properly consider the legislative history of section 562 as an aid to its construction. *Cf. Commissioner* v. *Bilder,* 369 U.S. 499 (1962), *rev'g* 289 F.2d 291 (3rd Cir. 1961).

(4) That history, derived from the committee reports, specifically refers to section 27(d) of the Internal Revenue Code of 1939 as being "incorporated" and "contained" in the 1954 Code. H.R. Rep. No. 1337, 83rd Cong., 2d Sess. A181 (1954), 1954 U.S. Code Cong. & Admin. News 4320;[3] S. Rep. No. 1635, 83rd Cong., 2d Sess. 325 (1954), 1954 U.S. Code Cong. & Admin. News 4965-66.[4] Section 27(d)

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[3] The House Report reads as follows:

SECTION 562. *Rules applicable in determining dividends eligible for dividends paid deduction*

Subsection (a) provides that the term "dividend" for purposes of this part shall include, except as otherwise provided in this section, only those dividends described in section 312 (relating to definitions of dividends for purposes of corporate distributions). The requirements of sections 27(d), (e), (f), and (i) of existing law are incorporated in the definition of "dividend" in section 312, and accordingly are not restated in section 562.

[4] The Senate Report reads as follows:

SECTION 562. *Rules applicable in determining dividends eligible for dividends paid deduction*

This section conforms to section 562 of the House bill except for a clerical amendment.

Subsection (a) provides that the term "dividend" for purposes of this part shall include, except as otherwise provided in this section, only those dividends described in section 316 (re-

provided that the dividends paid credit for personal holding company taxes was to be computed at "the adjusted basis of the property in the hands of the corporation at the time of payment, or the fair market value of the property at the time of payment, whichever is lower". 26 U.S.C. § 27(d) (1952).[5] The valuation standard of section 27(d)

lating to definition of dividends for purposes of corporate distributions). The requirements of sections 27(d), (e), (f), and (i) of existing law are contained in the definition of "dividend" in section 312, and accordingly are not restated in section 562.

[5] Some explanation of the legislative history as it refers to the incorporation of section 27(d) of the 1939 Code in the 1954 Code is required. The House Report places the requirements of section 27(d) in section 312 of the House Bill. The Senate Report, while by terms also placing the requirements of section 27(d) in "section 312", raises the inference that the Senate actually meant that requirements of section 27(d) had been placed in section 316 of the Senate Bill. This inference is supported by several pieces of circumstantial evidence. Section 316 of the Senate Bill, which became section 316 of the 1954 Code, was originally section 312 of the House Bill. The first sentence of the two-sentence Senate discussion of section 562(a) (which otherwise reproduces the House discussion almost verbatim) makes the numbering adjustment from section 312 of the House Bill to section 316 of the Senate Bill. Yet the second sentence of the Senate discussion makes continued and unaccountable reference to "section 312". Finally, the reference in the Senate discussion to section 312 is factually incorrect. The Senate Report states that the requirements of section 27(d) "are contained in the definition of 'dividend' in Section 312 . . . ." In point of fact, however, there is neither a definition of nor even a reference to the term "dividend" in section 312. It was section 316 of the Code as enacted and not section 312 that Congress denominated as "Dividend defined". Based upon examination of the legislative history of section 562, the court must conclude that the reference to "section 312" in the second sentence of the Senate Report's discussion of section 562(a) is a typographical error. Further, the court must agree with plaintiffs that defendant is erroneously relying upon section 312 of the Code as the valuation provision for the personal holding company tax.

In addition to negating the relevance of the specific provision relied upon by the defendants, however, the legislative history of section 562 also plays an affirmative role in construction of the Code. The portion of the legislative history relevant for purposes

relevant to the issue here is embodied in the Treasury Regulation, 26 C.F.R. § 1.562-1(a),[6] which permits a dividends paid deduction by the personal holding company only to the extent of the holding company's adjusted basis of the property distributed. The court will defer to the regulation promulgated by the Commissioner of Internal Revenue acting within his statutory authority unless it should appear that the regulation is plainly inconsistent with the Code or is unreasonable.

(5) The regulation is not in conflict with sections 301, 316 or 562 of the Code, and nothing has been presented to the court to demonstrate inconsistency with any other sections. In light of the clear Congressional intention evidenced in the legislative history of section 562 to implant the valuation principle of section 27(d) of the 1939 Code in the 1954 Code, and the Congressional purpose in enact-

of construction of section 562 is the expressed Congressional intent to incorporate section 27(d) of the 1939 Code. After allowance is made for the typographical error in the Senate Report, it appears clear from the legislative history that Congress believed it was incorporating the requirements of section 27(d) in section 316 of the 1954 Code.

The plaintiffs, therefore, are correct in asserting that the legislative history of section 562 is marred by typographical error and that once this typographical error is accounted for it becomes clear that Congress did not intend section 312 of the 1954 Code to provide a valuation provision for the corporation's distribution of securities. Nevertheless, the substance of the defendant's contention that the legislative history here supports the result it seeks is unimpaired by close examination of the primary texts relied upon by Congress in considering the 1954 Code.

[6] 26 C.F.R. § 1.562-1(a), in pertinent part, provides:

(a) *General rule.* Except as otherwise provided in section 562 (b) and (d), the term "dividend", for purposes of determining dividends eligible for the dividends paid deduction, refers only to a dividend described in section 316 (relating to definition of dividends for purposes of corporate distributions). . . . If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution. . . .

ing the undistributed personal holding company tax, there is nothing unreasonable in a regulation permitting disparity between the valuation of the property distributed as dividends, when allowed as a deduction to the personal holding company in computing its taxable undistributed income, and the valuation of the same property when subject to the tax imposed upon income to shareholders. Even if the personal holding company tax, 26 U.S.C. § 541 *et seq.*, is a penalty, and therefore to be construed narrowly against defendant, *Commissioner* v. *Acker*, 361 U.S. 87 (1959), where the Congressional purpose is explicitly revealed in the legislative history,[7] the Treasury Regulation is consistent with that purpose, and there is no statutory language that supports the construction urged by the taxpayer, the court will accord full weight to the regulation. *See Commissioner* v. *Bilder, supra* at 504.

Accordingly, defendant's motion for summary judgment is granted, and plaintiffs' motion is hereby denied.

(s) FRANK J. MURRAY
United States District Judge

Dated: January 22, 1976

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[7] *Cf. Ivan Allen Co.* v. *United States*, 422 U.S. 617 (1975). The Supreme Court in the last term illustrated the manner in which technical valuation issues surrounding a penalty tax are to be addressed in *Ivan Allen* when it construed certain provisions of the accumulated earnings tax, a tax, like the personal holding company tax, designed by Congress to minimize the opportunities for tax avoidance offered by the differential between personal and corporate income taxes. *Ivan Allen* noted that the accumulated earnings tax was "a penalty and therefore to be strictly construed". *Id.* at 627. Nevertheless, the Court also felt bound to construe the statute in light of the purpose envisioned for the tax evidenced by the structure of the accumulated earnings provisions. *Id.* at 626-27. After doing so the Court found in favor of the Government. The analysis that the court gives here to the personal holding company tax is similar to that given the accumulated earnings tax by the Court in *Ivan Allen*. For even conceding that the statute must be strictly construed against the defendant here, the court must give full weight to the Congressional intent evidenced in the legislative history.

APPENDIX C

Statutory Provisions Involved

INTERNAL REVENUE CODE OF 1954, AS AMENDED, UNITED STATES CODE, TITLE 26

Sec. 541. Imposition of Personal Holding Company Tax.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 70 percent of the undistributed personal holding company income.

Sec. 545. Undistributed Personal Holding Company Income.

(a) *Definition* — For purposes of this part, the term "undistributed personal holding company income", means the taxable income of a personal holding company adjusted in the manner provided in subsections (b), (c), and (d), minus the dividends paid deduction as defined in section 561. In the case of a personal holding company which is a foreign corporation, not more than 10 percent in value of the outstanding stock of which is owned (within the meaning of section 958(a)) during the last half of the taxable year by United States persons, the term "undistributed personal holding company income" means the amount determined by multiplying the undistributed personal holding company income (determined without regard to this sentence) by the percentage in value of its outstanding stock which is the greatest percentage in value of its outstanding stock so owned by United States persons on any one day during such period.

• • • •

Sec. 547. Deduction for Deficiency Dividends.

(a) GENERAL RULE — If a determination (as defined in subsection (c)) with respect to a taxpayer establishes liability for personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law) for any taxable year, a deduction shall be allowed to the taxpayer for the amount of deficiency dividends (as defined in subsection (d)) for the purpose of determining the personal holding company tax for such year, but not for the purpose of determining interest, additional amounts, or assessable penalties computed with respect to such personal holding company tax.

* * * *

(d) DEFICIENCY DIVIDENDS —

(1) *Definition* — For purposes of this section, the term "deficiency dividends" means the amount of the dividends paid by the corporation on or after the date of the determination and before filing claim under subsection (e), which would have been includible in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if distributed during such taxable year. No dividends shall be considered as deficiency dividends for purposes of subsection (a) unless distributed within 90 days after the determination.

(2) *Effect on Dividends Paid Deduction* —

(A) *For Taxable Year in Which Paid* — Deficiency dividends paid in any taxable year (to the extent of the portion thereof taken into account under subsection (a) in determining personal holding company tax) shall not be included in the amount of dividends paid for such year for purposes of computing the dividends paid deduction for such year and succeeding years.

(B) *For Prior Taxable Year* — Deficiency Dividends paid in any taxable year (to the extent of the

portion thereof taken into account under subsection (a) in determining personal holding company tax) shall not be allowed for purposes of section 563(b) in the computation of the dividends paid deduction for the taxable year preceding the taxable year in which paid.

* * * *

Sec. 561. Definition of Deduction for Dividends Paid.

(a) GENERAL RULE — The deduction for dividends paid shall be the sum of —

(1) the dividends paid during the taxable year,

(2) the consent dividends for the taxable year (determined under section 565), and

(3) in the case of a personal holding company, the dividend carryover described in section 564.

(b) SPECIAL RULES APPLICABLE —

(1) In determining the deduction for dividends paid, the rules provided in section 562 (relating to rules applicable in determining dividends eligible for dividends paid deduction) and section 563 (relating to dividends paid after the close of the taxable year) shall be applicable.

* * * *

Sec. 562. Rules Applicable in Determining Dividends Eligible for Dividends Paid Deductions.

(a) GENERAL RULE — For purposes of this part, the term "dividend" shall, except as otherwise provided in this section, include only dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions).

* * * *

Sec. 316. Dividend Defined.

(a) GENERAL RULE — For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

(b) SPECIAL RULES —

• • • •

(2) Distributions By Personal Holding Companies —

(A) In the case of a corporation which —

(i) under the law applicable to the taxable year in which the distribution is made, is a personal holding company (as defined in section 542), or

(ii) for the taxable year in respect of which the distribution is made under section 563(b) (relating to dividends paid after the close of the taxable year), or section 547 (relating to deficiency dividends), or the corresponding provision of prior law, is a personal holding company under the law applicable to such taxable year,

the term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) made by the corporation to its shareholders, to the

extent of its undistributed personal holding company income (determined under section 545 without regard to distributions under this paragraph) for such year.

• • • •

Sec. 301. Distributions of Property.

(a) IN GENERAL — Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) AMOUNT DISTRIBUTED —

(1) *General Rule* — For purposes of this section, the amount of any distribution shall be —

(A) *Noncorporate Distributees* — If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) *Corporate Distributees* — If the shareholder is a corporation unless subparagraph (D) applies, the amount of money received, plus whichever of the following is the lesser:

(i) the fair market value of the other property received; or

(ii) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b), (c), or (d) of section 311, under section 341(f), or under section 617(d)(1), 1245(a), 1250(a), 1251 (c) or 1252(a).

• • • •

(2) *Reduction for Liabilities* — The amount of any distribution determined under paragraph (1) shall be reduced (but not below zero) by —

(A) the amount of any liability of the corporation assumed by the shareholder in connection with the distribution, and

(B) the amount of any liability to which the property received by the shareholder is subject immediately before, and immediately after, the distribution.

(3) *Determination of Fair Market Value*—For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) AMOUNT TAXABLE — In the case of a distribution to which subsection (a) applies —

(1) *Amount Constituting Dividend*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * * *

(d) BASIS — The basis of property received in a distribution to which subsection (a) applies shall be —

(1) *Noncorporate Distributees* — If the shareholder is not a corporation, the fair market value of such property.

(2) *Corporate Distributees*—If the shareholder is a corporation, unless subparagraph (3) applies, whichever of the following is the lesser:

(A) the fair market value of such property; or

(B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property, increased in the amount of gain to the distributing corporation which is recognized under subsection (b), (c), or (d) of section 311, under section 341(f), or under section 617(d)(1), 1245(a), 1250(a), 1251(c), or 1252(a).

* * * *

Supreme Court, U. S.
FILED
AUG 6 1977
MICHAEL RODAK, JR., CLERK

APPENDIX

In the Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-1137

ARTHUR FULMAN, ET AL., TRUSTEES,
PETITIONER,

v.

UNITED STATES OF AMERICA,
RESPONDENT.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

PETITION FOR CERTIORARI FILED FEBRUARY 17, 1977
CERTIORARI GRANTED MAY 23, 1977

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Civil Action No. 73-1109-M

PIERCE INVESTMENT CORP.,
PLAINTIFF,
v.
UNITED STATES OF AMERICA,
DEFENDANT.

DOCKET ENTRIES

1973		
Apr.	10	Complaint filed. Summons issued.
June	7	Defendant's answer filed.
1974		
Mar.	13	Marshal's return of summons with service made on 4/11/73, filed.
Aug.	8	Stipulation of facts filed.
	28	Plaintiff's motion for leave to amend complaint, assented to, filed.
Sept.	10	MURRAY, J. Re plaintiff's motion for leave to amend complaint. All copies to counsel.
Nov.	4	Defendant's motion for summary judgment, filed.
	4	Defendant's memorandum in support of its motion for summary judgment.
	5	Plaintiff's motion for summary judgment, filed.
	5	Plaintiff's memorandum of law, filed.
	22	Plaintiff's reply to defendant's memorandum of law, filed.
	25	Defendant's reply memorandum in support of its motion for summary judgment, filed.
Dec.	20	MURRAY, J. ORDER, entered. (Plaintiffs shall file within 7 days a statement in support of their motion for summary judgment) Copies to counsel.

1974

31 MURRAY, J. ORDER, entered. (Defendant shall file within 7 days of receiving statement in support of its motion for summary judgment) Copies to counsel.

1975

Jan. 9 Letter dated 1/7/75 to Judge Murray from J. Fink, U.S. Dept. of Justice, Washington, D.C. enclosing a copy of stipulation of facts (filed 8/8/74), filed.

9 MURRAY, J. ORDER, entered. "The parties shall within ten (10) days of the date of this order file memoranda specifying objections, if any, to the materiality or relevancy of any stipulated fact, and supporting the objections by citations of authority." Copies to counsel.

13 Letter dated 1/10/75 to Judge Murray from J. Fink, U.S. Dept. of Justice, Washington, D.C. informing him that the defendant has no objection to any fact contained in the stipulation filed 8/8/74, filed.

15 Letter dated 1/14/75 to Judge Murray from J. Margolis, Esq., counsel for the plaintiff, stating that he has no objections to the stipulation of facts previously filed in the case, filed. (Per Judge Murray's Order of 1/9/75).

Apr. 17 Copy of letter dated 4/14/75 to J. Margolis, Esq. from U.S. Dept. of Justice, re substitution of corrected page 4 of a memorandum, filed.

Aug. 28 Letter to Judge Murray from Jonathan J. Margolis dated 8/26/75 re: Plaintiff's desire to waive hearing on motions for summary judgment, filed.

1975

Sept. 9 Letter to Judge Murray from Jonathan J. Margolis dated 9/5/75 enclosing a copy of a decision in the District Court for the Western District of Louisiana, filed.

10 Letter to Judge Murray dated 8/29/75 from Jerome Fink, Chief, Refund Trial Section No. 1, Dept. of Justice, advising that the defendant waives oral argument on the motions for summary judgment, filed.

1976

Jan. 22 MURRAY, J. MEMORANDUM AND ORDER ENTERED re plaintiff's and defendant's motions for summary judgment: ". . . deft's motion for summary judgment is granted, and pltfs' motion is hereby denied."

23 MURRAY, J. JUDGMENT ENTERED . . . "Judgment for the deft; complaint dismissed."

29 MURRAY, J. AMENDMENT TO FOOTNOTE IN MEMORANDUM AND ORDER OF JANUARY 22, 1976, ENTERED. Footnote 5 amended by striking out the sentence beginning with the words "In point of fact" and substituting the sentence "In point of fact, however, there is no definition of the term 'dividend' in section 312."

Mar. 12 Plaintiff's Notice of Appeal filed.

Apr. 21 Certified copy of docket entries and original pleadings forwarded to the Court of Appeals.

UNITED STATES COURT OF APPEALS
FOR THE FIRST CIRCUIT

Case No. 76-1165

ARTHUR S. FULMAN, ET AL.,
PLAINTIFFS, APPELLANTS,
v.
UNITED STATES OF AMERICA,
DEFENDANT, APPELLEE.

[545 F.2d 268]

GENERAL DOCKET

1976

Apr. 23 Record on appeal, in one volume, filed and case docketed.
28 Appearance of Daniel D. Levenson and Jonathan J. Margolis for appellants received and filed.
30 Designation of contents of joint appendix received and filed.
May 3 Appearance of Scott P. Crampton and Gilbert E. Andrews for appellee filed.
28 Appendix to briefs and brief for appellant filed.
June 17 Brief for appellee filed.
18 Appearances of Gary R. Allen and Alfred S. Lombardi for appellee filed.
24 Reply brief for appellants filed.
Aug. 30 Assigned for hearing at September session.
Sept. 8 Heard by Coffin, Clark and Campbell, J.J.
Nov. 19 Judgment: The judgment of the District Court is affirmed. Opinion of the Court by Coffin, Ch.J. Notices mailed.

1976

Dec. 8 Verified and itemized bill of costs filed.
13 Taxation of costs filed. Mandate issued, copy filed and original papers returned to the district court. Notices mailed.

1977

Feb. 23 Notice of filing petition for certiorari filed (76-1137) Feb. 17, 1977.
May 31 Order of Supreme Court granting certiorari May 23, 1977.

UNITED STATES DISTRICT COURT
FOR THE
DISTRICT OF MASSACHUSETTS

CIVIL ACTION
No. 73-1109-M

PIERCE INVESTMENT CORP.,
PLAINTIFF,
v.
UNITED STATES OF AMERICA,
DEFENDANT.

COMPLAINT

1. This action is brought pursuant to Section 7422 of the Internal Revenue Code, Title 26, United States Code. This Court has original jurisdiction of the action under Title 28, Sections 1346(a)(1); and 1402 of the United States Code. The action seeks refund of taxes erroneously and illegally assessed and collected by the Commissioner of Internal Revenue.

2. Plaintiff is a corporation organized under the laws of the Commonwealth of Massachusetts. Plaintiff's usual place of business is located at 6 Pleasant Street, Malden, Massachusetts.

3. For the calendar years 1962 and 1963, the Plaintiff was a personal holding company, as defined in Section 542 of the Internal Revenue Code and was therefore liable to the tax imposed by Section 541 of the Internal Revenue Code.

4. Pursuant to Section 547 of the Internal Revenue Code the Plaintiff, on November 28, and December 31, 1966, declared deficiency dividends in order to extinguish its liability for tax under Section 541 of the Internal Revenue Code. (Copies of the records of these meetings are attached as Exhibit A). The deficiency dividends were paid in the form of securities having a fair market value of $32,535. Payment of a dividend in that amount would have eliminated Plaintiff's liability for tax under Section 541 of the Internal Revenue Code, which was determined to be $26,571.30. (A copy of Form 2198, Determination of Personal Holding Company Liability, reflecting this amount, is attached as Exhibit B).

5. Plaintiff timely filed, on January 24, 1967, Form 976, Claim For Deficiency Dividends Deduction, claiming deductions in the amount of $32,535. (A copy of this Form 976 is attached as Exhibit C).

6. Plaintiff's claim for deficiency dividends was denied to the extent that the amount claimed by Plaintiff exceeded Plaintiff's basis in the property distributed. As a result deficiencies were assessed for the calendar years 1962 and 1963 in the amounts of $2,981 and $8,095 respectively.

7. The deficiencies assessed were paid by the Plaintiff.

8. The Plaintiff filed timely claims for refund of the amounts paid. These claims were denied by letters dated June 3, 1971. (Copies of those letters are attached as Exhibit D).

9. The Internal Revenue Code of 1954, Title 26, United States Code, provides no justification for denying Plaintiff a deficiency dividends deduction equal to the fair market value of the property transferred.

WHEREFORE, Plaintiff prays that:

1. This Court determine that the assessment and collection of personal holding company tax under Section 541 of the Internal Revenue Code for the Calendar years 1962 and 1963 was erroneous and illegal.

2. This Court order a refund of the erroneously and illegally assessed and collected [tax], together with interest thereon as provided by law.

3. This Court award costs to the Plaintiff, as provided in Title 28, United States Code, Section 2412.

4. This Court grant such other relief as is just and proper.

PIERCE INVESTMENT CORP.
by its Attorneys
DANIEL D. LEVENSON
JONATHAN J. MARGOLIS

EXHIBIT A

I, Morris Fulman, Clerk of Pierce Investment Corp., hereby certify that the following is a true copy of the record of the minutes of a meeting of the Board of Directors of Pierce Investment Corp. held November 28, 1966, at which a quorum was present and voting.

"The President reported that the corporation had been determined to be a Personal Holding Company as defined in the Internal Revenue Code and consequently that a personal holding company tax deficiency was proposed against the corporation in the total amount of $26,571.30 for the taxable years 1959, 1960, 1962, and 1963. The President further reported that the personal holding company tax could be eliminated if "deficiency dividends", as defined in Section 547(d)(1) of the Internal Revenue Code are declared and paid to the stockholders in accordance with the procedures of said Section 547.

Upon motion made and duly seconded, it was

VOTED: That the corporation distribute to its stockholders cash or property with a fair market value on the date of distribution of $32,202.00, such distribution to take place within ninety days of November 3, 1966.

Upon motion made and duly seconded, it was

VOTED: That the President is herewith authorized to execute any documents required to effect the "deficiency dividends" deduction."

s/ MORRIS FULMAN
MORRIS FULMAN — *Clerk*

A true copy
ATTEST:

I, Morris Fulman, Clerk of Pierce Investment Corp., hereby certify that the following is a true copy of the record of the minutes of a meeting of the Board of Directors of Pierce Investment Corp. held on December 31, 1966, at which a quorum was present and voting.

"The President reported that as of December 1, 1966, the value of Schering Corporation stock was $55 per share, and the value of Gulf Corporation was $59 per share. He recommended that distribution be made to each of the stockholders as follows:

55 shares of Schering Corporation @ $55	— $3,025
10 shares of Gulf Corporation @ $59	— $ 590
	$3,615.

This would make a total distribution of $32,535.

On motion duly made and seconded, it was unanimously

VOTED: That the corporation distribute to each of its stockholders as a dividend 55 shares of Schering Corporation at $55 per share — $3,025, and 10 shares of Gulf Corporation at $59 per share — $590, totalling $3,615, in place of the dividend voted on November 28, 1966, in the total amount of $32,202."

s/ MORRIS FULMAN
MORRIS FULMAN — *Clerk*

A true copy
ATTEST:

EXHIBIT B

Form 2198
(Rev. May 1963)

U.S. TREASURY DEPARTMENT—INTERNAL REVENUE SERVICE

DETERMINATION OF LIABILITY FOR
PERSONAL HOLDING COMPANY TAX
Section 547(c)(3) of the Internal Revenue Code of 1954

Name of Taxpayer
Pierce Investment Corp.

Address of Taxpayer (*Number, street, city, postal zone, State*)
6 Pleasant Street, Malden, Massachusetts

The above-named taxpayer and the Commissioner of Internal Revenue agree that the taxpayer is liable for personal holding company tax and other income tax in the amount(s) and for the taxable year(s) shown below.

Taxable Year	Personal Holding Company Liability	Other Income Tax Liability	Total Income Tax Liability
1959	$4,796.30		$4,796.30
1960	8,374.00		8,374.00
1962	5,306.00	$21.00	5,327.00
1963	8,095.00		8,095.00

It is understood that if this determination is signed on behalf of the Commissioner, three signed copies will be sent to the taxpayer at the last known address by registered or certified mail; and that the date of registration (if sent by registered mail) or the date of the postmark on the sender's receipt (if sent by certified mail) shall be the date of determination. If, however, a deficiency dividend is paid before such registration or postmark date but on or after the date this agreement is signed on behalf of the Commissioner, the date of determination shall be such date of signing.

Corporate Name
PIERCE INVESTMENT CORP.

Signature of Officer	Title	Date
s/ David Borr	Pres.	10/19/66

Signature for the Commissioner
s/ Eugene F. Baritot

Title	Date
Asst. Chief Audit Div.	11/1/66

NOTE: This determination does not constitute a final closing agreement under Section 7121 of the Internal Revenue Code of 1954.

The determination must be signed with the corporate name, followed by the signature and title of the officers empowered to sign for the corporation, and the seal of the corporation must be affixed. If the corporation has no seal, a certified copy of the resolution of the board of directors giving the officer authority to sign must accompany the determination.

EXHIBIT C

FORM 976
(Rev. Apr. 1964)

U.S. TREASURY DEPARTMENT—INTERNAL REVENUE SERVICE

CLAIM FOR DEFICIENCY DIVIDENDS DEDUCTION OR CREDIT OR REFUND UNDER SECTION 547 OF THE INTERNAL REVENUE CODE

To be filed in duplicate. See Instructions on page 3.

1a. Name of Corporation
Pierce Investment Corp.

1b. Employer Identification number
04-6039354

2. Address (*Number and street, city or town, and State*)
6 Pleasant Street, Malden, Massachusetts 02148

3. Incorporated under the laws of
Massachusetts

4. Date
12/27/46

5. Amount of deficiency determined under subchapter C, Part II, of Chapter 1
$26,571.30

6. Taxable year or years involved
1959, 1960, 1962 and 1963

7. Amount of unpaid deficiency
$26,571.30

8. (a) If deficiency paid in whole or in part, amount thereof
None

9. If unpaid, how was deficiency established?
(Check) [ ] Tax Court decision
[ ] court judgment
[ ] closing agreement
[X] agreement under section 547(c)(3)
Date 11/1/66

• • •

14. Date deficiency dividend was paid in accordance with resolution of board of directors, or other authority, certified copy of which is attached hereto.
Date 12/31/66

15. Deficiency dividend was paid as follows:
Cash $ None
Other property: Fair market value $32,535
Adjusted cost basis $
State nature of other property
495 shares at $55 per share of Schering Corporation—$27,225 and 90 shares of Gulf Corporation at $59 per share—$5,310, totaling $32,525.

16. Amount of earnings and profit accumulated since February 28, 1913, and on hand at date of payment of deficiency
$42,096.76

17. Total amount of each class of stock outstanding at date of payment of deficiency dividend.
180 shares of common no par stock, 20 shares of which are held by each stockholder.

18.

Name and address of each shareholder	*Class of stock and number of shares of each class held at date of payment of deficiency dividend*	*Amount of such dividend paid to each shareholder on each class of stock*
(1) Max O. Berman, 320 Ferry St., Malden, Mass.	20 shares, no par common	$3,615
(2) David Borr, 497 Fellsway East, Malden, Mass.	20 shares, no par common	3,615

(3) Albert A. Frank, 265 Fellsway East, Malden, Mass.	20 shares, no par common	3,615
(4) Sydney Freedman, 59 Acorn Street, Malden, Mass.	20 shares, no par common	3,615
(5) Morris Fulman, 163 Hawthorne Street, Malden, Mass.	20 shares, no par common	3,615
(6) Ezra Green, 109 Savin Street, Malden, Mass.	20 shares, no par common	3,615
(7) Burton C. Grodberg, 547 Fellsway East, Malden, Mass.	20 shares, no par common	3,615
(8) Harry Reinherz, 24 Bartlett Street, Malden, Mass.	20 shares, no par common	3,615
(9) Matt D. Cooper, 30 Bartlett Street, Malden, Mass.	20 shares, no par common	3,615

19. Amount claimed as deficiency dividends deduction $32,202
20. Amount to be refunded $ none
21. Amount to be credited $ none

22. The time within which this claim may be legally filed expires, under section 547(e) of the Internal Revenue Code, on March 3, 1967. The claimant believes that this claim should be allowed for the following reasons:
The claimant has complied with the provisions of Code Section 547 and the regulations thereunder.

DECLARATION

Under penalties of perjury, I declare that this claim has been made on proper authorization, has been examined by me and is, to the best of my knowledge and belief, a true, correct, and complete statement of facts, made in good faith, pursuant to section 547 of the Internal Revenue Code and the regulations issue thereunder.

Pierce Investment Corp.
(*Name of corporation*)

[CORPORATE SEAL] s/ DAVID BORR
(*Name of officer*)

RECEIVED
CONFERENCE STAFF
JAN 25 1967
BOSTON DISTRICT

EXHIBIT D

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE CENTER AAJS MC MP
NORTH ATLANTIC REGION

DATE: June 3, 1971
IN REPLY REFER TO: RSC-105

CERTIFIED MAIL
Pierce Investment Corp.
6 Pleasant St.
Malden, MA 02148

Social Security Number or Employer Identification Number: 04-6039354
Document Locator Number: 04-351-108-40100-3
Type of Tax: 1120 Corporation Income Return
Period Ending: Dec. 31, 1962
Amount Claimed: $2,960.21
Date Claim Received: 1-24-67

Dear Taxpayer:

We have examined your claim for an adjustment of your taxes. I am sorry to tell you that we cannot allow your claim for the reasons stated below. This decision rests on certain provisions of the internal revenue laws and regulations.

This letter is your legal notice that your claim is disallowed in full.

If you wish to begin suit or proceedings for the recovery of any taxes, penalties, or other moneys for which this notice of disallowance is issued, the law requires you to do so within 2 years from the mailing date of this letter.

Sincerely yours,
s/ F. L. BROWITT
Director

Reasons for disallowance:
Per audit letter dated 2-1-71 from appellate office,
Boston, Mass.

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE CENTER AAJS MC MP
NORTH ATLANTIC REGION

DATE: June 3, 1971
IN REPLY REFER TO: RSC-105

CERTIFIED MAIL
Pierce Investment Corp.
6 Pleasant St.
Malden, MA 02148

Social Security Number or Employer Identification Number: 04-6039354
Document Locator Number: 04-351-108-40101-4
Type of Tax: 1120 Corporation Income Return
Period Ending: Dec. 31, 1963
Amount Claimed: $8,095.00
Date Claim Received: 6-26-70

Dear Taxpayer:

We have examined your claim for an adjustment of your taxes. I am sorry to tell you that we cannot allow your claim for the reasons stated below. This decision rests on certain provisions of the internal revenue laws and regulations.

This letter is your legal notice that your claim is disallowed in full.

If you wish to begin suit or proceedings for the recovery of any taxes, penalties, or other moneys for which this notice of disallowance is issued, the law requires you to do so within 2 years from the mailing date of this letter.

Sincerely yours,
s/ F. L. BROWITT
Director

Reasons for disallowance:
Per audit letter dated 2-1-71 from appellate office,
Boston, Mass.

[Title Omitted In Printing]

ANSWER

The defendant, the United States of America, by its attorney, James N. Gabriel, Acting United States Attorney for the District of Massachusetts, in response to the complaint answers and states as follows:

1. Admits the allegations contained in paragraph 1 of the complaint except denies that any taxes were erroneously and illegally assessed and collected from the plaintiff by the Commissioner of Internal Revenue.

2. Admits the allegations contained in paragraph 2 of the complaint.

3. Admits the allegations contained in paragraph 3 of the complaint.

4. Admits the allegations contained in paragraph 4 of the complaint.

5. Admits the allegations contained in paragraph 5 of the complaint.

6. Admits the allegations contained in the first sentence of paragraph 6 and lacks sufficient knowledge to form a belief as to the truth of the allegations contained in the second sentence of paragraph 6 of the complaint.

7. Lacks sufficient knowledge to form a belief as to the truth of the allegations contained in paragraph 7 of the complaint.

8. Admits the allegations contained in paragraph 8 of the complaint.

9. Denies the allegations contained in paragraph 9 of the complaint.

WHEREFORE, having answered each and every allegation in the complaint, the defendant demands judgment in its favor with costs to be paid by plaintiff.

JAMES N. GABRIEL
United States Attorney
By: s/ W. B. HOLLINGSWORTH
WAYNE B. HOLLINGSWORTH
Asst. United States Attorney

[Certificate Of Service Omitted In Printing]

[Title Omitted In Printing]

STIPULATION OF FACTS

The parties hereto, by and through their counsel, stipulate for the purpose of this civil action that the facts set forth below are true. However, they reserve to themselves the right to object to the materiality or the relevancy of any of said facts.

1. The plaintiff in the above-styled case is Pierce Investment Corp., having its principal place of business at 6 Pleasant Street, Malden, Massachusetts.

2. The defendant is the United States of America.

3. This action is brought by the plaintiff for the refund of Personal Holding Company tax imposed pursuant to Section 541 for the years 1962 and 1963.

4. Pursuant to an audit of the plaintiff's U.S. Corporation Income Tax Returns for the years 1959, 1960, 1962 and 1963 it was determined by the District Director, Boston, Massachusetts, that the plaintiff was a personal holding company as defined in Section 542(a) of the Internal Revenue Code.

5. As the result of the above determination the following personal holding company tax was proposed:

1959	$4,796.30
1960	8,374.00
1962	5,306.00
1963	8,095.00

6. The District Director's determination was incorporated in Form 2198, Determination of Liability for Personal Holding Company Tax pursuant to Section 547(c)(3) of the Internal Revenue Code of 1954. A true and exact copy of such form is attached hereto and made a part hereof as Exhibit No. 1.

7. Pursuant to Section 547 of the Internal Revenue Code, the plaintiff on November 28, 1966, declared a deficiency dividend in the amount of $32,535, the payment of which would eliminate the plaintiff's liability for the personal holding company tax. A true and exact copy of the minutes of the Board of Directors of the Plaintiff dated November 28, 1966, declaring the above deficiency dividend is attached hereto and made a part hereof as Exhibit No. 2.

8. On December 31, 1966, the plaintiff satisfied the deficiency dividend declaration by distributing to each shareholder 55 shares of Schering Corporation stock, and 10 shares of Gulf Oil Corporation stock. Attached hereto and made a part hereof as Exhibit No. 3 is a true and exact copy of the minutes of the plaintiff's Board of Directors' meeting held on December 31, 1966.

9. The plaintiff's total adjusted basis of the above securities distributed as the deficiency dividend was $18,725.11, while the fair market value of the same was $32,535.

10. On January 24, 1967, the plaintiff timely filed Form 976, Claim for Deficiency Dividends Deduction, claiming deductions in the amount of $32,535. A true and exact copy of the above claim is attached hereto and made a part hereof as Exhibit No. 4.

11. Plaintiff's claim for deficiency dividends deduction was denied by the District Director to the extent that the amount claimed by plaintiff, $32,535, exceeded the plaintiff's basis, $18,725.11, in the property distributed. As a result personal holding company tax deficiencies were as-

sessed on April 18, 1969, for the calendar years 1962 and 1963 in the amounts of $2,960.21 and $8,095.00, respectively.

12. On or about April 22, 1969, the plaintiff paid the above deficiencies in full. In addition the plaintiff on September 21, 1970, paid $180.04 representing interest on the personal holding company tax deficiency for 1962, and on April 22, 1970, the plaintiff paid $2,967.08, representing interest on the 1963 deficiency, ($3.31 was later refunded to the plaintiff).

13. Subsequently, the plaintiff filed timely claims for refund of the above amounts. True and exact copies of the plaintiff's claims for refund for 1962 and 1963 are attached hereto and made a part hereof as Exhibits Nos. 5 and 6, respectively.

14. On June 3, 1971, the plaintiff's claims for refund were rejected by the District Director of Internal Revenue by certified mail.

15. This Court has jurisdiction over the parties and the subject matter of this action by virtue of Section 1346 (a)(1), Title 28, United States Code.

s/MICHAEL VON MANDEL
Attorney for Defendant
s/JONATHAN J. MARGOLIS
Attorney for Plaintiff

EXHIBIT NO. 1

Exhibit No. 1 is printed above as Exhibit B to the Complaint at pp. 10-11.

EXHIBIT NOS. 2 AND 3

Exhibits No. 2 and No. 3 are printed above as Exhibit A to the Complaint at pp. 8-9.

EXHIBIT NO. 4

Exhibit No. 4 is printed above as Exhibit C to the Complaint at pp. 11-13.

EXHIBIT NO. 5

FORM 843
(Rev. June 1968)
U.S. Treasury Department
Internal Revenue Service

CLAIM

Name of taxpayer or purchaser of stamps
Pierce Investment Corp.

Number and street: 6 Pleasant St.
City or town, State, and ZIP Code: Malden, Mass. 02148

FILL IN APPLICABLE ITEMS—Use attachments if necessary

• • •

b. Employer identification number (if any)
04-6039354

c. Internal Revenue Service office where return (if any) was filed
Mass.

• • •

e. Period—if for tax reported on annual basis, prepare separate form for each taxable year
From January 1, 1962 to December 31, 1962

f. Kind of tax
Personal Holding Company

g. Amount of assessment: $2,960.21
Dates of payment: October 30, 1969

• • •

i. Amount to be refunded (if income tax, complete computation below)
$2,960.21

• • •

k. The claimant believes that this claim should be allowed for the following reasons:
See attached statement.

Under penalties of perjury, I declare that I have examined this claim, including accompanying schedules and statements, and to the best of my knowledge and belief it is true, correct, and complete.

s/ DAVID BORR

Dated 11/6/1969 — DAVID BORR, President

A determination was made that the taxpayer was a personal holding company for the taxable year 1962 and on November 1, 1966, Form 2198 was signed by a representative of the Commissioner of Internal Revenue.

On or about December 27, 1966, the taxpayer, pursuant to a vote of the Board of Directors, caused to be distributed to its stockholders securities with a sufficient fair market value to effect a distribution of all its undistributed personal holding company income. These distributions were reflected by the individual stockholders on their 1966 income tax returns as dividends to the extent of the fair market value of the securities received.

On January 24, 1967, Form 976, Claim for Deficiency Dividends Deduction, was filed with the Internal Revenue Service, claiming a deduction for the fair market value of the securities distributed. The Revenue Agent has improperly allowed a deficiency dividend deduction only for the cost basis of the securities distributed, and the personal holding company tax has been imposed on the difference between the cost basis and the fair market value of the distributed securities.

The taxpayer's claim is based upon the following analysis:

1. Under Section 547 "the term a 'deficiency dividend' means the amount of the dividends paid by the corporation on or after the date of the determination and before filing claim under subsection (e), which would have been includible in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if distributed during such taxable year. • • •"

2. Section 561(a)(1) provides that "the deduction for dividends paid shall include the dividends paid during the taxable year."

3. Section 562(a) provides that "the term 'dividend' shall, except as otherwise provided in this section, include only dividends described in Section 316. . . ."

4. Under Section 316(a) a dividend means any distribution of property made by a corporation to its shareholders out of its current or accumulated earnings and profits.

5. Under Section 301(b)(1)(A), the amount of any corporate distribution to a non-corporate distributee is the amount of money received plus the fair market value of the other property received.

6. Regulation 1.316-1(a)(3) Example illustrates that the amount taxable as a dividend includes the fair market value, not merely the adjusted basis, of the property distributed.

The taxpayer alleges that there is no statutory justification for disallowing a deduction for "deficiency dividends" to the extent of the fair market value of the property distributed by the taxpayer to its stockholders, and that the assertion of a deficiency based upon the difference between the cost basis and fair market value of the securities distributed was improper.

PIERCE INVESTMENT CORP.
By s/DAVID BORR
President

EXHIBIT NO. 6

FORM 843
(Rev. Nov. 1968)
Department of the Treasury
Internal Revenue Service

CLAIM

Name of taxpayer or purchaser of stamps
Pierce Investment Corp.

Number and street: 6 Pleasant Street
City or town, State, and ZIP Code: Malden, Massachusetts 02148

FILL IN APPLICABLE ITEMS—Use attachments if necessary

• • •

b. Employer identification number (if any)
04-6039354

c. Internal Revenue Service office where return (if any) was filed
Mass.

• • •

e. Period—if for tax reported on annual basis, prepare separate form for each taxable year
From January 1, 1963 to December 31, 1963

f. Kind of tax
Personal Holding Company

g. Amount of assessment: $8,095.00
Dates of payment: April 23, 1970

• • •

i. Amount to be refunded (if income tax, complete computation below)
$11,062.08

• • •

k. The claimant believes that this claim should be allowed for the following reasons:
[See attached statement.]

Dated April 30, 1970

PIERCE INVESTMENT COMPANY
s/ DAVID BORR, President

SELECTED–FA
8-5-70

North Atlantic Service Center
Andover, Mass. 01812
JUN 26 1970
RECEIVED
I.R.S.

A determination was made that the taxpayer was a personal holding company for the taxable years 1962 and 1963 and on November 1, 1966, Form 2198 was signed by a representative of the Commissioner of Internal Revenue.

On or about December 27, 1966, the taxpayer, pursuant to a vote of the Board of Directors, caused to be distributed to its stockholders securities with a sufficient fair market value to effect a distribution of all its undistributed personal holding company income. These distributions were reflected by the individual stockholders on their 1966 income tax returns as dividends to the extent of the fair market value of the securities received.

On January 24, 1967, Form 976, Claim for Deficiency Dividends Deduction, was filed with the Internal Revenue Service, claiming a deduction for the fair market value of the securities distributed. The Revenue Agent has improperly allowed a deficiency dividend deduction only

for the cost basis of the securities distributed, and the personal holding company tax has been imposed on the difference between the cost basis and the fair market value of the distributed securities.

The taxpayer's claim is based upon the following analysis:

1. Under Section 547 "the term a 'deficiency dividend' means the amount of the dividends paid by the corporation on or after the date of the determination and before filing claim under subsection (e), which would have been includible in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if distributed during such taxable year. • • •"

2. Section 561(a) (1) provides that "the deduction for dividends paid shall include the dividends paid during the taxable year."

3. Section 562(a) provides that "the term 'dividend' shall, except as otherwise provided in this section, include only dividends described in Section 316. . . ."

4. Under Section 316(a) a dividend means any distribution of property made by a corporation to its shareholders out of its current or accumulated earnings and profits.

5. Under Section 301(b)(1)(A), the amount of any corporate distribution to a non-corporate distributee is the amount of money received plus the fair market value of the other property received.

6. Regulation 1.316-1(a)(3) Example illustrates that the amount taxable as a dividend includes the fair market value, not merely the adjusted basis, of the property distributed.

The taxpayer alleges that there is no statutory justification for disallowing a deduction for "deficiency dividends" to the extent of the fair market value of the property distributed by the taxpayer to its stockholders, and

that the assertion of a deficiency based upon the difference between the cost basis and fair market value of the securities distributed was improper.

[Title Omitted In Printing]

MOTION FOR LEAVE TO AMEND THE COMPLAINT

1. This action was timely commenced by a complaint filed on April 10, 1973.

2. The above-named Plaintiff has been liquidated, and its assets transferred to Arthur S. Fulman and Neil A. Cooper, Trustees of the Pierce Investment Corp. Stockholders Trust under the provisions of applicable local law and Section 337 of the Internal Revenue Code of 1954.

WHEREFORE, Plaintiff prays that Arthur S. Fulman and Neil A. Cooper, Trustees of the Pierce Investment Corp. Stockholders Trust, be substituted as Plaintiffs in this action.

PIERCE INVESTMENT CORP.
by its Attorney
s/ JONATHAN J. MARGOLIS
JONATHAN J. MARGOLIS

ASSENT:

The defendant offers no objection to the substitution of Arthur S. Fulman and Neil A. Cooper, Trustees of the Pierce Investment Corp. Stockholders Trust, as plaintiffs in this action, provided that the substitution in no way limits the rights of the defendant which it is otherwise entitled to under the law.

s/ MICHAEL VON MANDEL
MICHAEL VON MANDEL
Trial Attorney
Tax Division
Department of Justice
Washington, D.C. 20530

[Title Omitted In Printing]

PLAINTIFFS' MOTION FOR SUMMARY JUDGMENT

Plaintiff moves the court as follows:

1. That it enter, pursuant to Rule 56 of the Federal Rules of Civil Procedure, a summary judgment in plaintiffs' favor for the relief demanded in the complaint on the ground that there is no genuine issue as to any material fact and that plaintiff is entitled to a judgment as a matter of law. This motion is based upon:

(a) The stipulation of facts filed on August 8, 1972.

(b) Plaintiffs' memorandum of law, filed herewith.

ARTHUR S. FULMAN,
NEIL A. COOPER,
Trustees of
Pierce Investment Corp.
Stockholders Trust
By their attorneys
s/ DANIEL D. LEVENSON
DANIEL D. LEVENSON
s/ JONATHAN J MARGOLIS
JONATHAN J. MARGOLIS
Both of:
LOURIE & CUTLER
1 State Street
Boston, MA 02109
742-6720

[Title Omitted In Printing]

DEFENDANT'S MOTION FOR SUMMARY JUDGMENT

Comes now the defendant, United States of America, by its attorney, James N. Gabriel, United States Attorney for the District of Massachusetts, and moves that judgment be entered in its favor, dismissing the complaint herein with prejudice and granting such costs to the defendant as are authorized by law, pursuant to Rule 56 of the Federal Rules of Civil Procedure, on the grounds that all relevant facts have been stipulated and that the defendant is entitled to judgment as a matter of law, all of which is set forth in detail in defendant's memorandum in support of its motion submitted herewith.

JAMES N. GABRIEL
United States Attorney
By s/ JAMES J. O'LEARY
JAMES J. O'LEARY
Assistant U.S. Attorney

Of Counsel:
MICHAEL VON MANDEL
Trial Attorney
Tax Division
Department of Justice
Washington, D.C. 20530
Telephone: (202) 739-3583

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

CIVIL ACTION
No. 73-1109-M

ARTHUR S. FULMAN Et Al,
PLAINTIFFS,
v.
UNITED STATES OF AMERICA,
DEFENDANT.

AMENDMENT TO FOOTNOTE IN MEMORANDUM AND ORDER OF JANUARY 22, 1976

Footnote 5 is amended by striking out the sentence beginning with the words "In point of fact" and substituting therefor the following sentence:

> In point of fact, however, there is no definition of the term "dividend" in section 312.

The amendment does not deal with any matter of substance but is made for the purpose of accuracy and to avoid any possible misleading connotation of the word "reference" in the sentence which is stricken.

s/ FRANK J. MURRAY
United States District Judge

January 29, 1976

Supreme Court, U. S.
FILED
MAY 6 1977
MICHAEL RODAK, JR., CLERK

No. 76-1137

In the Supreme Court of the United States

OCTOBER TERM, 1976

ARTHUR FULMAN, ET AL., TRUSTEES, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE UNITED STATES

WADE H. McCREE, JR.,
Solicitor General,
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1976

No. 76-1137

ARTHUR FULMAN, ET AL., TRUSTEES, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

MEMORANDUM FOR THE UNITED STATES

The petition in this federal income tax case seeks resolution of a question with respect to which there is a conflict in the circuits concerning the computation of the deficiency dividends deduction under the personal holding company tax imposed by Section 541 of the Internal Revenue Code of 1954, as amended (26 U.S.C.). The question presented is whether a personal holding company's distribution of appreciated property to its shareholders results in a deduction from undistributed personal holding company income in an amount equal to the corporation's adjusted basis in the distributed property, as the court of appeals held, or the fair market value of the property at the time of the distribution, as petitioners contend.

Petitioners are the successors to, and transferees of assets of, Pierce Investment Company (Pierce). On audit, the

Commissioner of Internal Revenue concluded that Pierce was a personal holding company, as defined in Section 542(a) of the Code, for the years 1959, 1960, 1962, and 1963, and determined deficiencies in personal holding company taxes of $26,571.30 (Pet. App. A, pp. 9-10; R. 20-21).[1]

Pursuant to the deficiency dividend procedures provided by Section 547 of the Code, Pierce agreed to the Commissioner's determination of its personal holding company tax liability and, within 90 days after executing the agreement, distributed to its shareholders appreciated stock that it held in other companies. The stock had a fair market value of $32,535 at the time of distribution; its adjusted basis in Pierce's hands was $18,725.11. Pierce then filed a claim under Section 547 of the Code for a deficiency dividends deduction of $32,535 (Pet. App. A, pp. 9-10; R. 21).

Pursuant to Treasury Regulations, Section 1.562-1 (a) (26 C.F.R.), the Commissioner disallowed the claimed deduction to the extent that it exceeded Pierce's adjusted basis in the distributed stock and assessed a tax on the remaining undistributed personal holding company income (Pet. App. A, p. 10).

In this refund suit brought by Pierce in the United States District Court for the District of Massachusetts, the district court upheld the validity of the governing Treasury Regulations and concluded that Pierce's dividends paid deduction was limited to its adjusted basis in the distributed stock (Pet. App. B, pp. 18-24).[2] The court of appeals affirmed (Pet. App. A, pp. 8-17).

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[1]"R." refers to the record appendix filed in the court of appeals.

[2]Pierce was dissolved while this action was pending before the district court and petitioners were substituted as the plaintiffs.

holding that by limiting the dividends paid deduction to the adjusted basis of the distributed stock, the Regulations were consistent with the objective of the personal holding company tax to impose a penalty on a corporation's realized undistributed passive income.

1. The marginal tax rate applicable to corporations is substantially lower than that applicable to individuals. In the absence of a statutory corrective, the differential between corporate and individual tax rates would permit high-bracket individual taxpayers to transfer passive investment property to closely held corporations, accumulate the income, and then sell or liquidate the corporations at capital gains rates, thereby achieving a lower net tax than if they had held the property outright.

Since 1934, the personal holding company tax has supplied the necessary corrective. Generally speaking, it is a special tax, imposed in addition to the ordinary income tax, on the income from passive investments that has been accumulated by a "personal holding company," which is defined by Section 542(a) of the Code as a corporation more than 50 percent of whose stock is owned, actually or constructively, by five or fewer individuals. The tax is imposed if at least 60 percent of a personal holding company's adjusted ordinary gross income for the year is "personal holding company income," which Section 543 defines primarily as passive investment income such as dividends, rents, and interest. When it applies, the personal holding company tax is 70 percent of the corporation's undistributed personal holding company income.

Once the Commissioner determines that a corporation is liable for the personal holding company tax, however, the corporation may avoid the tax by distributing its personal holding company income to its shareholders; such

distributions give rise to a "dividends paid deduction" that reduces the amount of undistributed personal holding company income to which the tax applies. See Sections 541, 545, and 561 of the Code. Thus the personal holding company tax is an inducement to the distribution of realized passive investment income to shareholders in the form of taxable dividends. See Libin, *Personal Holding Companies and the Revenue Act of 1964*, 63 Mich. L. Rev. 421, 422-424 (1965).

The question presented in this case concerns the computation of the dividends paid deduction when a personal holding company distributes appreciated property rather than cash to its shareholders. Petitioners claim a dividends paid deduction equal to the fair market value of the appreciated property that was distributed to shareholders after determination of liability for the personal holding company tax. The government's position, which is set forth at Treasury Regulations, Section 1.562-1 (a) (see Appendix, *infra*, pp. 1a-2a), and was sustained by the courts below, is that the dividends paid deduction with respect to in-kind distributions is limited to the distributing corporation's adjusted basis in the property.

2. The limitation on the dividends paid deduction provided by Section 1.562-1(a) of the Regulations is both reasonable and consistent with the statutory scheme. The personal holding company tax is intended to prevent the tax avoidance that would result if realized investment income that would otherwise be taxable at progressive rates applicable to individuals could be accumulated at the corporate level. The net effect of the tax is to induce personal holding companies to distribute all of their passive investment income to the shareholders, or risk imposition of the penalty tax. But if a corporation

could distribute appreciated property to its shareholders and claim a dividends paid deduction equal to the fair market value of the property, it could retain part of its passive investment income and nevertheless avoid the personal holding company tax on such income. Section 1.562-1(a) of the Regulations therefore provides that the dividends paid deduction is limited to the corporation's basis in distributed property, *i.e.*, the amount of corporate earnings actually invested in the distributed property. Since the Regulation is consistent with the objectives of the personal holding company tax, the court of appeals correctly upheld its validity. See, *e.g.*, *Bingler* v. *Johnson*, 394 U.S. 741; *Commissioner* v. *South Texas Co.*, 333 U.S. 496.

Petitioners contend that personal holding companies should be entitled to a dividends paid deduction equal to the fair market value of property distributed in kind at the time of the distribution. But petitioners' market value rule would permit personal holding companies to accumulate passive investment income and shelter it from the personal holding company tax by distributing appreciated property to its shareholders. Moreover, as the court of appeals pointed out (Pet. App. A, pp. 16-17), acceptance of petitioners' argument would lead to disparate treatment of personal holding companies that had equal amounts of personal holding company income but invested their income in property that appreciated at different rates.

Finally, as the court of appeals observed (Pet. App. A, pp. 11-14), the pertinent legislative history supports the validity of the Commissioner's Regulation providing that the amount of the dividend paid deduction is equal to the adjusted basis of the distributed property. Section 27(d) of the Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)) expressly provided that the amount of a deduction for dividends paid in kind was either the corporations's adjusted

basis in the property or the fair market value, whichever was less. While Congress did not include Section 27(d) in the 1954 Code, the Senate Finance Committee Report with respect to Section 562(a) indicates that the rule of Section 27(d) was to be carried over into the 1954 revision. Thus, the Committee Report stated that "The requirements of sections 27(d) * * * of existing law are contained in the definition of 'dividend' in section 312, and accordingly are not restated in section 562." S. Rep. No. 1622, 83d Cong., 2d Sess. 325 (1954). The legislature history therefore suggests that Congress did not intend to abrogate the adjusted basis rule of Section 27(d) of the 1939 Code.

3. We agree with petitioners that the decision below conflicts with *H. Wetter Manufacturing Co.* v. *United States*, 458 F. 2d 1033 (C.A. 6). There, as here, a personal holding company distributed appreciated securities to its shareholders. The court held that the corporation was entitled to a Section 562 dividends paid deduction equal to the fair market value of the securities on the date of distribution. In so holding, the Sixth Circuit concluded that Section 1.562-1(a) of the Regulations was invalid. Accord: *Gulf Inland Corp.* v. *United States*, No. 74-157, decided July 16, 1975 (W.D. La.) (75-2 U.S.T.C. Para. 9620), appeal pending, No. 75-3767 (C.A. 5), argued April 19, 1977.[3]

The question of the proper computation of the dividends paid deduction involved in this case is pertinent to other provisions of the Internal Revenue Code in addition to the

[3]Recently, in *C. Blake McDowell, Inc.* v. *Commissioner*, 67 T.C. No. 87 (decided March 30, 1977), a majority of the Tax Court expressed the view that Treasury Regulations, Section 1.562-1(a), was valid, but held for the taxpayer under the Tax Court's *Golsen* rule because an appeal would lie to the Sixth Circuit where *Wetter* would be controlling. See *Golsen* v. *Commissioner*, 54 T.C. 742, 756-758, affirmed on the substantive issue, 445 F. 2d 985 (C.A. 10), certiorari denied, 404 U.S. 940.

personal holding company tax. As petitioners note (Pet. 5), the dividends paid deduction is applicable to the accumulated earnings tax (see Section 535(a)). But it also applies to the foreign personal holding company tax (see Section 556(a)), and the provisions governing regulated investment companies and real estate investment trusts (see Sections 852(b), 857(b)).

We are advised by the Internal Revenue Service that there are 12 personal holding company cases and three accumulated earnings tax cases presently pending with $375,000 and $316,000, respectively, at stake. In addition to the cases presented to three different circuits in the last five years, the Service advises that within the last two years, nine personal holding company tax cases and one accumulated earnings tax case presenting the question were closed administratively. Those cases involved a total of $743,000. Thus, while the issue does not appear to have substantial administrative importance at the present time in terms of the revenue, the question arises with some frequency and the Commissioner and the tax bar should have the benefit of a uniform national rule. We therefore do not oppose the granting of the petition for a writ of certiorari.

Respectfully submitted.

WADE H. MCCREE, JR.,
Solicitor General.

MAY 1977.

DOJ-1977-05

APPENDIX

Treasury Regulations on Income Tax (26 C.F.R.):

§1.562-1 *Dividends for which the dividends paid deduction is allowable.*

(a) *General rule.* Except as otherwise provided in section 562(b) and (d), the term "dividend", for purposes of determining dividends eligible for the dividends paid deduction, refers only to a dividend described in section 316 (relating to definition of dividends for purposes of corporate distributions). No distribution, however, which is preferential within the meaning of section 562(c) and § 1.562-2 shall be eligible for the dividends paid deduction. Moreover, when computing the dividends paid deduction with respect to a U.S. person (as defined in section 957(d)), no distribution which is excluded from the gross income of a foreign corporation under section 959(b) with respect to such person or from gross income of such person under section 959(a) shall be eligible for such deduction. Further, for purposes of the dividends paid deduction, the term "dividend" does not include a distribution in liquidation unless the distribution is treated as a dividend under section 316(b)(2) and paragraph (b)(2) of § 1.316-1, or under section 333(e)(1) and paragraph (c) of § 1.333-4 or paragraph (c)(2), (d)(1)(ii), or (d)(2) of § 1.333-5, or qualifies under section 562(b) and paragraph (b) of this section. If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution. See paragraph (b)(2) of this section for special rules with respect to liquidating distributions by personal holding companies occurring

during a taxable year of the distributing corporation beginning after December 31, 1963. Also see section 563 for special rules with respect to dividends paid after the close of the taxable year.

* * * * *

Supreme Court, U. S.
FILED
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MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1977

No. 76-1137

ARTHUR FULMAN, Et Al, TRUSTEES,
PETITIONERS,

v.

UNITED STATES OF AMERICA,
RESPONDENT

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE PETITIONERS

DANIEL D. LEVENSON
LESLIE CRANE SLAVIN
One State Street
Boston, Massachusetts 02109
(617) 742-6720
Attorneys for Petitioners

Of Counsel:
LOURIE & CUTLER
One State Street
Boston, Mass. 02109

Blanchard Press, Inc., Boston, Mass. — Law Printers

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BRIEF FOR THE PETITIONERS

Opinions Below

The opinion of the United States District Court for the District of Massachusetts (App. B to Petition for Certiorari at 18) is reported at 407 F. Supp. 1039. The opinion of the U.S. Court of Appeals for the First Circuit (App. A to Petition for Certiorari at 8) is reported at 545 F.2d 268.

Jurisdiction

The judgment of the Court of Appeals for the First Circuit was entered on November 19, 1976. The petition for a writ of certiorari was filed on February 17, 1977, and was granted on May 23, 1977. This Court's jurisdiction is invoked under 28 U.S.C. section 1254(1).

Question Presented

Whether the dividends paid deduction allowable under section 561 of the Internal Revenue Code of 1954 should be measured by the fair market value of property distributed as a dividend in kind to individual stockholders, as Petitioners contend, or by the adjusted basis of such property to the distributing corporation, as Respondent contends.

Statutory Provisions Involved

Pursuant to Rule 40(1)(c), the text of the relevant portions of Title 26 U.S.C. are reproduced in the Appendix to this Brief.

Sec. 531 — Imposition of Accumulated Earnings Tax
Sec. 535 — Accumulated Taxable Income
Sec. 541 — Imposition of Personal Holding Company Tax
Sec. 545 — Undistributed Personal Holding Company Income
Sec. 547 — Deduction for Deficiency Dividends
Sec. 561 — Definition of Deduction for Dividends Paid
Sec. 562 — Rules Applicable in Determining Dividends Eligible for Dividends Paid Deduction
Sec. 301 — Distributions of Property
Sec. 312 — Effect on Earnings and Profits
Sec. 316 — Dividend Defined

Statement of the Case

This is a tax refund suit involving the application of sections 545, 547, 561 and 562 of Title 26 U.S.C., the Internal Revenue Code of 1954, as amended,[1] which provide for a reduction in the amount of undistributed personal holding company income subject to the personal holding company tax if the corporation makes certain dividend distributions to its shareholders.

Petitioners are the successors of the Pierce Investment Corp. (hereinafter referred to as "Taxpayer"), a Massachusetts corporation.

On November 1, 1966, the Internal Revenue Service determined that the Taxpayer had, for the years 1959, 1960, 1962, and 1963, been a personal holding company within the meaning of section 542(a) of the Internal Revenue Code. As a result, personal holding company taxes in the following amounts were assessed for the four years in question:

1959	$4,796.30
1960	8,374.00
1962	5,306.00
1963	8,095.00
Total	$26,571.30

On November 28, 1966, Taxpayer availed itself of the provisions of section 547 which permits a taxpayer to eliminate its liability for the personal holding company tax by declaring a dividend, termed a "deficiency dividend",

[1] Unless otherwise specified, citations to statutory provisions are to sections of the Internal Revenue Code of 1954, as amended (hereinafter the "Code"), codified in Title 26 of the United States Code.

at least equal to its prior years' undistributed personal holding company income. On that date, Taxpayer declared a deficiency dividend in the amount of $32,535, intending thereby to eliminate its liability. On December 31, 1966, Taxpayer satisfied its dividend declaration by distributing to each shareholder 55 shares of Schering Corporation stock and 10 shares of Gulf Oil Corporation stock. The fair market value of the stock distributed was $32,535, and its adjusted basis in the hands of the Taxpayer was $18,725.11.

Taxpayer timely filed a claim under section 547 of the Code for a dividends paid deduction of $32,535, the fair market value of the stock it had distributed. This claim was disallowed by the Internal Revenue Service to the extent that the amount claimed ($32,535) exceeded the Taxpayer's adjusted basis in the securities distributed ($18,725.11). As a result, the Internal Revenue Service, on April 18, 1969, assessed deficiencies in personal holding company tax for the calendar years 1962 and 1963 in the amounts of $2,960.21 and $8,095.00 respectively.

Taxpayer paid the assessed deficiencies, together with interest, in full, and timely filed a claim for refund of the tax paid. The Internal Revenue Service disallowed Taxpayer's claim for refund on June 3, 1971.

On April 10, 1973, Taxpayer instituted this action in the United States District Court for refund of the taxes paid. The case was decided on stipulated facts and cross motions for summary judgment. The District Court held in favor of the Government. On appeal, the First Circuit affirmed the District Court.

Introduction and Summary of Argument

Under our system of income taxation, which imposes potentially higher rates of tax on individuals than on corporations, an incentive exists for the individual to accumulate his income in a corporation, thereby shielding

part of his income from higher personal tax rates. The need to deter such actions has been recognized by Congress since 1913 and was specifically addressed in the enactment of both the accumulated earnings tax and the personal holding company tax.

The accumulated earnings tax, set forth in sections 531 through 537 of the Code, is imposed over and above the ordinary corporate income tax, upon the "accumulated taxable income" of any corporation which is found to have been utilized for the purpose of minimizing the income tax imposed on its shareholders by permitting its earnings to accumulate beyond the reasonable needs of its business. The personal holding company tax, set forth in sections 541 through 547 of the Code, is imposed on the "undistributed personal holding company income" of any corporation which meets the criteria, set forth in section 542, defining a personal holding company. A corporation will be classified as a personal holding company if, for a given tax year, more than 50% of its stock is owned, directly or constructively, by five or fewer individuals and if 60% or more of its adjusted gross income is derived from certain specified sources — such as interest, dividends, and other forms of passive investment income. The two taxes are mutually exclusive.

Because the number of stockholders in a corporation may vary, the sources of its income may change, and its reasonable business needs may fluctuate, corporations can, from year to year, slip in and out of the classifications mandating the application of either tax.

Since both the accumulated earnings tax and the personal holding company tax were designed to insure taxation at the shareholder level by inducing corporations to make dividend distributions, both statutory provisions relieve corporations of the tax altogether if they make such distributions in sufficient amounts. This is done by providing for

a "dividends paid deduction" in the calculation of accumulated taxable income (the base upon which the accumulated earnings tax is levied) in section 535(a), and in the calculation of undistributed personal holding company income (the base upon which the personal holding company tax is levied) in section 545(a). Section 562, which sets forth the rules for determining dividends eligible for the dividends paid deduction, states that:

> For purposes of this part, the term "dividend" shall, except as otherwise provided in this section, include only dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions).

This case focuses upon the dividends paid deduction available to a corporation distributing property other than cash to an individual shareholder. The question presented is whether the dividends paid deduction should be equal to the fair market value of the property distributed or its adjusted basis in the hands of the distributing corporation.

The Government maintains that the appreciation or depreciation of property distributed, for purposes only of the dividends paid deduction, should be disregarded. It has adopted this position in Treas. Reg. §1.562-1(a) which states, in part, as follows:

> If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of distribution.

Petitioners submit that this regulation is invalid and that a corporation distributing a dividend in kind should instead receive a dividends paid deduction equal to the amount included in income by the shareholder-distributees

by virtue of such dividend. Petitioner adopts this position for the following reasons:

1. The purpose of both the personal holding company tax and the accumulated earnings tax is to insure taxation at the shareholder level by inducing corporations to make dividend distributions in sufficient amounts. The only principle of valuing dividends in kind for purposes of the dividends paid deduction which is consistent with this purpose is that the dividends paid deduction should equal the amount taxable to the recipient shareholder, as determined under Code sections 301 and 316.

2. An examination of the language and the legislative history of the Code provisions involved in this case reveals an intention on the part of Congress that reference be made to Code section 301, the section which governs taxation of dividends to shareholders, for the determination of the amount of the dividends paid deduction.

3. The use of fair market value to determine the dividends paid deduction is consistent with this Court's decision in the case of *Ivan Allen* v. *United States*, 422 U.S. 617 (1975), which held that for purposes of determining the applicability of the accumulated earnings tax, appreciated marketable securities would be taken into account at their fair market value. The Government's position adopted in Treas. Reg. §1.562-1(a) is inconsistent with that decision.

4. Treas. Reg. §1.562-1(a) leads to results which are inconsistent with the purpose underlying both the accumulated earnings tax and the personal holding company tax by permitting corporations to escape the full impact of these taxes without making distributions to the full extent intended by Congress.

Argument

I. Consistency With Statutory Purpose Requires That a Corporation Should Receive a Dividends Paid Deduction Equal to the Amount Included in Income by the Shareholder-Distributee.

An understanding of the Congress' purpose in enacting the accumulated earnings and personal holding company taxes is necessary to understand the rationale for Petitioners' position that a corporation distributing a dividend in kind should receive a dividends paid deduction equal to the amount included in income by the shareholder-distributee by virtue of such dividend. Both the personal holding company tax and the accumulated earnings tax were drafted to address a problem inherent in a tax system that taxes individuals at higher rates than it taxes corporations, i.e. both taxes were designed to deter taxpayers from insulating income from the graduated personal income tax by accumulating that income in a corporate entity. Neither tax was conceived of as a direct means of raising federal revenues. "The personal holding company surtax, like the surtax imposed by Section 102 [the predecessor of the accumulated earnings tax], was not intended to produce revenue *per se*. Instead, its primary purpose was to induce, or rather force, the distribution of the income of personal holding companies to their stockholders so that the latter would become liable to surtax on such income." Harry J. Rudick, "Section 102 and Personal Holding Company Provisions of the Internal Revenue Code," 49 Yale L.J. 171, 176 (1939); see B. Bittker and J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, §8.01 at 8-3, and §8.20 at 8.35 (3d ed. 1971).

The historical evolution of these taxes demonstrates clearly that their purpose is to insure taxation at the shareholder level. In fact, both the personal holding company tax and the accumulated earnings tax stem from provisions in the very early versions of the Code which imposed a tax directly on a corporation's shareholders (based on their pro rata shares of corporate earnings) if the corporation was found to be improperly accumulating income. Tariff Act of 1913, ch. 16, Sec. II A(2), 38 Stat. 166. However, after this Court's decision in *Eisner* v. *Macomber*, 252 U.S. 189 (1920), doubts arose as to the constitutionality of such a tax when no dividend had been distributed by the corporation. Thus, in 1921, Congress removed the burden of the tax from the shareholder and placed it on the corporation. Revenue Act of 1921, ch. 136, Title II, sec. 220, 42 Stat. 247. However, the corporation could avoid the tax if the shareholders included the accumulated earnings of the corporation in their own taxable income.[2] "If the surtax is thus paid the failure to distribute the earnings has not resulted in any avoidance of tax and the reason for the imposition of the [accumulated earnings] tax on the corporation no longer exists." S. Rep. No. 52, 69th Cong., 1st Sess. 22 (1926); 1939-1 Cum. Bull. (Part 2) 332, 349.

Congressional intent to structure these taxes so as to compel distributions equal to the income realized by the corporation is further evidenced by the following passage from the Senate Finance Committee Report explaining the personal holding company tax provisions of the Revenue Act of 1934:

> Many will consider the surtax imposed on these personal holding companies a harsh measure. However, a corporation which falls within this section be-

[2] This provision was the forerunner of the present section 565 which establishes a deduction for "consent dividends".

cause of the nature of its business and the number of its stockholders can always escape this tax by distributing to its stockholders at least 90 percent [now 100 percent] of its adjusted net income. The stockholder will, of course, be subject to the graduated surtaxes upon such distributions. Thus, the section should work no real hardship upon any corporation except one which is used to reduce surtaxes upon its shareholders. S. Rep. No. 558, 73d Cong., 2d Sess. 15 (1934); 1939-1 CUM. BULL. (Part 2) 586, 597.

Because the purpose of these taxes is to deter taxpayers from using corporations to accumulate income, the statutory purpose is fully accomplished upon the distribution to shareholders of amounts which will result in taxable income to shareholders equal to accumulated taxable income or undistributed personal holding company income. This is underscored by the several escape provisions afforded to corporations which are affected by these taxes. For example, section 563 permits a corporation to declare a dividend within 2½ months after the close of a taxable year and to apply that dividend to the prior year for purposes of the dividends paid deduction. In addition, Section 565 provides a procedure for shareholders to treat as a dividend a specified amount which, although not actually distributed by the corporation, will qualify for the dividends paid deduction. Furthermore, in the case of a corporation which has been determined to be liable for a personal holding company tax well after the 2½ month period has expired, section 547 permits the corporation to declare a "deficiency dividend" in order to avoid the imposition of the tax. It was under this procedure that Petitioner made its distribution.

Congress envisioned a coherent, logical and internally consistent system for dealing with improper accumulations

of income by corporations. Once it is recognized that the purpose of these provisions is to insure taxation at the shareholder level, it follows that Congress intended that a corporation making dividend distributions would receive a dividends paid deduction determined by the amount included in the taxable income of the shareholder-distributees. This rule provides the necessary and sufficient inducement to make the desired distribution. A deduction of an amount less than fair market value would be unnecessary to fulfill the statutory purpose. A deduction of an amount greater than fair market value would permit a corporation to escape the full impact of the tax without making a distribution in the amount intended by Congress. Therefore, the valuation principle most consistent with the statutory purpose is that a corporation's dividends paid deduction should equal the amount included in the income of the shareholder-distributees.

Under that principle, a corporation distributing a dividend to an individual will receive a dividends paid deduction equal to the fair market value of the property distributed, because non-corporate shareholders must include the fair market value of distributions in kind in their taxable income. Code section 301(b)(1)(A), 301(c)(1). However, if the shareholder receiving the dividend is a corporation, the distributing corporation will receive a dividends paid deduction equal to the lesser of the fair market value or the adjusted basis of the property distributed, because that is the amount which will be included in the income of the corporate shareholder. Code section 301(b)(1)(B), 301(c)(1).

The First Circuit below thought it anomalous that the deduction for dividends paid would depend upon the character of the recipient, a result it assumed Congress could not have intended. Quite to the contrary, however, because the statutory purpose is clearly fulfilled if the amount of the

dividends paid deduction is equivalent to the amount includible in the income of the shareholder, it follows that the amount of the dividends paid deduction must differ in these two situations since the amount includible in the shareholder's income differs.[3]

That the dividends paid deduction should be the amount included in income by the shareholder-distributee is not "anomalous", but rather accords with the very careful structuring of Code sections 301-318 dealing with corporate distributions to shareholders.

---

[3] The differentiation between corporate and non-corporate shareholders resulted from a deliberate decision to close a tax loophole available to corporations. This loophole, which was closed by the enactment of §301(b)(1)(B) in 1954, is well illustrated by an example in B. Bittker and J. Eustice, *supra*, ¶7.23:

> Assume that X (the distributing corporation) is wholly owned by A, another corporation. X, having earnings and profits of $100,000, distributes property to A with a value of $100,000 and an adjusted basis in its hands of $10,000. Were it not for section 301(b)(1)(B), A would have $100,000 of dividend income on receipt of the property; but, by virtue of the 85 percent deduction for intercorporate dividends provided by section 243 . . . , only $15,000 would be subject to tax. Thus, at trivial tax cost A could obtain a $100,000 stepped-up basis for computing depreciation and gain or loss on the distributed property. The "lower of value or basis" rule of section 301(b)(1)(B) avoids this result, with its attendant posibilities for manipulation, by providing that the "amount" of the distribution to A is only $10,000, the property's adjusted basis to X; similarly, section 301(d)(2) provides that A's basis for the property will be $10,000, its basis in the hands of X. If X was required to recognize $5,000 of gain on the distribution (e.g., because of section 1245), then the "amount" of A's section 301 distribution, and its basis for the distributed property, would be increased by the recognized gain to $15,000. (Footnotes omitted.)

The provisions of section 301(b)(1)(B) were thus drafted to remedy a tax abuse which stemmed from the tax treatment of intercorporate distributions. But for the existence of the dividends-received deduction available to corporate distributees, a distribution of property to a corporate stockholder would be valued at its fair market value.

II. Statutory History As Well As the Language of the Relevant Statutory Provisions Indicate That Congress Intended the Valuation Principles of Section 301 To Be Incorporated Into Section 316 and That the Dividends Paid Deduction Should Equal the Amount Included In Income By the Shareholder-Distributees.

The language of the relevant provisions of the Code, viewed in the light of their legislative history and statutory purposes, requires that the amount of the deduction for dividends paid under section 562 be equal to the amount includible in the income of shareholders as a dividend under section 301. In the cases of *H. Wetter Mfg. Co.* v. *United States*, 458 F.2d 1033 (6th Cir. 1972) and *Gulf Inland Corp.* v. *United States*, 75-2 USTC ¶9620 (W.D. La. 1975) (appeal docketed No. 75-3767, 5th Cir., Oct. 14, 1975), the courts found that the statutory language mandated this result and that Treas. Reg. §1.562-1(a) is invalid.

The First Circuit, however, failed to see that section 301 provides the rule for measuring the amount of a distribution under section 316 and thus under section 562. Petitioners believe that this oversight stemmed from the fact that the Court's attention was not drawn to the successive drafts of the bill which was enacted as the 1954 Code.

The statutory interrelationships among sections 562, 316 and 301 which were designed by Congress can best be understood by examining the pertinent provisions of H.R. 8300 83d Cong. 2d Sess. (1954) as it was introduced in the House of Representatives. Section 562(a) of that bill, provided, as (with the exception of a clerical amendment) does section 562(a) of the Code as enacted:

> For purposes of this part, the term "dividend" shall, except as otherwise provided in this section,

include only dividends described in section 312 (relating to definition of dividends for purposes of corporate distributions).

Section 312 of the House draft, which was referred to in the passage quoted above, contained the definition of the term "dividend," and is similar to section 316 of the Code as finally enacted. The pertinent part of that section stated as follows:

SECTION 312. DEFINITIONS RELATING TO CORPORATE DISTRIBUTIONS.

(a) DIVIDENDS

(1) GENERAL RULE. — The term "dividend" when used in this subtitle means *a distribution (as determined in section* 301(a)) of property by a corporation to its shareholders, which is —

(A) out of earnings and profits accumulated after February 28, 1913, or

(B) out of the earnings and profits of the taxable year .... (Emphasis supplied.)

The valuation rules of section 301(a) of the bill were thus specifically incorporated into the definition of dividend in section 312. Accordingly, we turn to section 301(a) of the House draft, which read:

SECTION 301. CORPORATE DISTRIBUTIONS OF SECURITIES AND PROPERTY — EFFECT ON SHAREHOLDER.

(a) IN GENERAL. — A distribution of securities or property by a corporation to a shareholder, other than in partial or complete liquidation as defined in section 336, shall be taxable to the extent provided in subsection (b), subject to the provisions of section 302 (relating to redemption of stock) and section 306 (relating to distributions of securities and property). *For this purpose, a "distribution" shall be considered to be the amount of money, and the fair market value of securities and property received, except that if the shareholder is a corporation receiving property the adjusted basis of which in the hands of the distributing corporation is less than its fair market value, the distribution shall be considered to be an amount not greater than such adjusted basis in the hands of the distributing corporation* increased in the amount of gain recognized to the distributing corporation by reason of such distribution. The amount of any such distribution shall be reduced by the amount of any indebtedness to which it is subject. (Emphasis supplied.)

Under the House drafts of section 301(a), section 312 and section 562, it is clear that a corporation distributing property (other than money) to a shareholder as a dividend would receive a deduction for dividends paid equal to the amount included as dividend income by the shareholder-distributee. If the shareholder were not a corporation, the deduction would equal the fair market value of the property distributed. If, on the other hand, the distribution were made to a corporate shareholder, the dividends paid deduction would equal the lesser of the adjusted basis or the fair market value of the property distributed.

To summarize, the language of the House draft of section 562(a) provided that one should look to section 312 of the draft to find the definition of dividends eligible for the dividends paid deduction. Section 312(a)(1) defined the term dividends as "a distribution (as determined in 301(a)" out of current or accumulated earnings and profits.

Section 301(a) then determined that "a 'distribution' shall be considered to be the amount of money, and the fair market value of securities received, except that if the shareholder is a corporation receiving property" the distribution shall be the lower of adjusted basis or fair market value.

In its consideration of the House draft of the bill, the Senate Finance Committee reorganized and reworded several sections. In the course of these revisions, section 312 in the House draft became section 316 of the present Code, the parenthetical reference in the House draft to 301(a) was dropped, and section 301(a) of the House draft was subdivided so that its provisions are now found in sections 301(a) and 301(b). These changes, however, were merely organizational and stylistic. In addition, the Senate also made some substantive changes to the House draft of the bill, but it was careful to mention those changes in the committee report explaining its draft. With respect to section 316, the Committee noted:

> [Y]our Committee has not adopted a rule which appeared in section 312(a) of the House bill, incorporating the principle of *Dixie Pine Products* v. *Commissioner*, (320 U.S. 516). This rule relates to the effect on earnings and profits where the liability for Federal income taxes is the subject of a bona fide contest by a taxpayer using the accrual method of accounting. S. Rep. No. 1622, 83d Cong., 2d Sess. 251-52; 3 U.S. Code Cong. & Adm. News 4621, 4889 (1954).

Thus, a substantive change was made to section 312 of the House draft (in an area which does not affect the outcome of this case), and this amendment was clearly explained in the Committee Report. With the exception of the abandonment of the rule of *Dixie Pine Products*, the Senate Finance Committee stated that section 316 of its draft "corresponds generally . . . to section 312(a) of the House bill." S. Rep. No. 1622, 83d Cong., 2d Sess. 251; U.S. Code Cong. & Adm. News, 4621, 4889 (1954).

Evidently, the Senate's elimination of the parenthetical reference to section 301(a) was considered to be merely a stylistic change. It was not considered to be substantive, for no mention of it was made in the Committee Report.

Apparently, the parenthetical reference was thought to be unnecessary because the words of the sections themselves incorporate the cross-reference. Section 316(a) of the Code states that "the term 'dividend' means *any distribution* of property made by a corporation to its shareholders", limited in amount by current and accumulated earnings and profits. Section 301(b)(1) (previously part of 301(a) of the House draft) specifically provides that "*the amount of any distribution* shall be —

> (A) Noncorporate Distributees — If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.
>
> (B) Corporate Distributees — If a shareholder is a corporation, unless subparagraph (D) applies, the amount of money received, plus whichever of the following is the lesser:
>
> (i) the fair market value of the other property received; or
>
> (ii) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b), (c), or (d) of section 311, under section 341(f), or under section 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a). (Emphasis supplied.)

Furthermore, section 301(c)(1) states as follows:

> (c) AMOUNT TAXABLE.—In the case of a distribution to which subsection (a) applies —
>
> (1) AMOUNT CONSTITUTING DIVIDEND. — That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

Clearly, then, section 316 was not intended to be read in isolation. Standing alone it provides no rule of valuation. It merely limits the amount of a distribution which can be a dividend. To determine the amount of the distribution, one must turn to section 301 of the Code. This scheme of statutory interrelationships is both clear both from the statutory history and from the words of the statute itself, and require, as Congress intended, that the dividends paid deduction be equal to the amount included in income by the shareholder-distributee.

III. CONSISTENCY WITH THIS COURT'S DECISION IN *Ivan Allen Co.* v. *United States* REQUIRES THAT PROPERTY DISTRIBUTED AS A DIVIDEND SHOULD BE VALUED AT FAIR MARKET VALUE FOR PURPOSES OF THE DIVIDENDS PAID DEDUCTION.

The proper computation of the dividends paid deduction is, as indicated above, pertinent to provisions of the Internal Revenue Code other than the personal holding company tax. The dividends paid deduction is also important in the calculation of accumulated taxable income (section 535(a)) for purposes of the accumulated earnings tax.[4]

[4] The calculation of the dividends paid deduction is also applicable to the provisions governing the calculation of undistributed foreign personal holding company income [section 556] as well as the provisions governing regulated investment companies and real estate investment trusts (sections 852(b), 857(b)).

In enacting these provisions, Congress aimed at the elimination of the same basic problem — the postponement of taxation of income at the progressive rate structure applicable to individuals by accumulation of income in a corporation. In the furtherance of this objective, Congress imposed a tax, in addition to the normal corporate income tax, if the criteria for liability under each respective section are satisfied.

Both the personal holding company tax and the accumulated earnings tax follow the same pattern in their application. Once the applicability of a particular tax has been determined, the current year's taxable income is adjusted to determine the amount subject to the tax. The adjustments prescribed are made primarily for the purpose of deriving an amount that more accurately reflects the corporation's net economic gain than does taxable income, and thus corresponds more closely to economic reality. See B. Bittker & J. Eustice, *supra*, §§8.09, 8.25. Thus, for example, the corporation's taxable income is reduced by federal taxes for the year and is increased by the 85 percent dividends received deduction permitted by section 243. Most relevant here is the deduction from taxable income of dividends paid by the corporation as defined in section 561, in order to arrive at the income subject to the additional tax.

In the case of *Ivan Allen* v. *United States*, 422 U.S. 617 (1975), this Court accepted the Government's position that in determining a corporation's liability for the accumulated earnings tax, the inquiry must focus on the corporation's true economic condition rather than on its balance sheet. More specifically, this Court held that in determining whether a corporation had accumulated earnings beyond the reasonably anticipated needs of its business, appreciated marketable securities should be valued at fair market value rather than at cost. The Court found that the tax is directed at economic reality. "Cost of the marketable securi-

ties on the assets side of the corporation's balance sheet would appear to be largely an irrelevant gauge of the taxpayer's true financial condition. Certainly, a lender would not evaluate a potential borrower's marketable securities at cost. Realistic financial condition is the focus of the lender's inquiry. It also must be the focus of the Commissioner's inquiry in determining the applicability of the accumulated earnings tax." 422 U.S. at 629-30 (footnote omitted).

The Court reached this conclusion by examining the structure of the accumulated earnings tax to determine its focus.

> The adjustments [made to taxable income before applying the tax] consist of the various items described in §535(b), including federal income tax, the deduction for dividends paid, defined in §561, and the accumulated earnigs credit defined in §535(c). The adjustments prescribed by §§535(a) and (b) are designed generally to assure that a corporation's "accumulated taxable income" reflects more accurately than "taxable income" the amount actually available to the corporation for business purposes. This explains the deductions for dividends paid and for federal income taxes; neither of these enters into the computation of taxable income ....
>
> The purport of the accumulated earnings tax structure established by §§531-537, therefore, is to determine the corporation's true economic condition before its liability for tax upon "accumulated taxable income" is determined. 422 U.S. at 626-27.

Thus, the purpose of the several adjustments made to taxable income before application of the additional taxes

is to arrive at a true reflection of the corporation's financial condition. "Obviously," the Court stated, "dividends paid and federal income taxes deplete corporate resources and must be recognized if the corporation's economic condition is to be properly perceived." 422 U.S. at 626.

The Court's analysis is equally applicable to the personal holding company tax, which follows the same basic structure in its application as the accumulated earnings tax. The logical consequence of this analysis is that the amount of a dividend paid in the form of securities should be measured by their fair market value. If, as the Government contends, the deduction allowed for dividends paid were to be calculated at the adjusted basis of property distributed as a dividend, this purpose would be thwarted. The property distributed could have risen steeply or fallen drastically in value since it was purchased. The cost of such property is simply an historical entry on the balance sheet, and bears little relation to the real financial condition of the corporation.[5]

Just as appreciated marketable securities are available for use in meeting the needs of the business to the extent of their fair market value, similarly, the assets of the corporation are depleted to the extent of fair market value when those securities are distributed. If, as was decided by this Court, a corporation's dividend paying capacity is to be measured by valuing its appreciated securities at fair market value, then the dividends actually paid must be measured in accordance with the same standards.

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[5] *See* Brief for the United States at 8, *Ivan Allen Co.* v. *United States*, 422 U.S. 617 (1975).

IV. Treasury Regulation Section 1.562-1(a), insofar as It Pertains to Valuation of Dividends Paid in Property, Is Invalid Because It Is Arbitrary and Leads to Results Which Are Inconsistent with the Statutory Purpose.

A. *The Regulation Is Arbitrary*

In promulgating a regulation, the Treasury Department is constrained by the principle that its interpretation of the Code must be reasonable and consistent with the will of Congress. An interpretive regulation cannot be arbitrary; it must derive from some manifestation of Congressional intent.

The First Circuit below, despite the holding of the Sixth Circuit in *Wetter*, concluded that the Code itself does not answer the question of how to determine the extent to which a dividend in kind may be used for the dividends paid deduction. Thus, the Court looked to external aids in interpreting the intent of Congress and in justifying Treas. Reg. §1.562-1(a). However, upon examining the principal bases of the Court's decision, it is clear that the foundations upon which it has constructed its rationale will not support the regulation. In fact, the regulation is the result of an arbitrary extension of administrative authority.

1. *Section 27(d) of the Code of 1939 does not support the Regulation.*

In upholding the Regulation, the First Circuit relied upon a statement in the Report of the Senate Finance Committee accompanying the draft of the bill which became the 1954 Code. The portion of the Senate Report relied upon is the following:

> *Section 562. Rules Applicable in Determining Dividends Eligible for Dividends Paid Deduction.*
>
> This section conforms to section 562 of the House bill except for a clerical amendment.
>
> Subsection (a) provides that the term "dividend" for purposes of this part shall include, except as otherwise provided in this section, only those dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions). The requirement of sections 27 (d), (e), (f), and (i) of existing law are contained in the definition of "dividend" in section 312,[6] and accordingly are not restated in section 562. S. Rep. No. 1622, 83d Cong., 2d Sess. 325; U.S. Code Cong. & Adm. News 4621, 4965-66 (1954).

The Court asserted that this statement indicates that Congress did not contemplate the abrogation of the rule of old section 27(d), and that the regulation should be upheld because it "substantially reflects" that rule. 545 F.2d at 270; Appendix A to Petition for Certiorari at 11.

Section 27(d) of the 1939 Code, to which the Senate Committee refers, provided a different rule for determining the amount of the dividends paid deduction under the 1939 Code. That section provided:

> (d) Dividends in Kind.—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the amount with respect thereto which shall be used in computing the basic surtax credit shall be the

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[6] The reference here to "section 312" is obviously a typographical error and is intended to be a reference to "section 316". *See* decision of the U.S. District Court in this case at its footnote 5 (Appendix B to Petition for Certiorari at 22).

> adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.[7]

We respectfully submit that the Court's conclusion is erroneous on at least two grounds.

First, with respect to the Committee Report, Petitioners maintain that Congress did not there indicate its intent to perpetuate the old valuation principle of the 1939 Code. Rather, it is submitted that Congress simply intended to indicate that the matters previously addressed in section 27 (which dealt only with the special taxes now grouped in subchapter G), would now be dealt with consistently throughout the Code and could therefore be encompassed by section 316 and its related provisions. We submit that this is the only logical interpretation of the reference to sections 27(d), (e), (f) and (i) in the Committee Reports. The rule of 27(d) is simply not contained in section 316; in fact, neither are the provisions of section 27(e) (dividends in obligations of the corporation), section 27(f) (taxable stock dividends) or section 27(i) (nontaxable distributions). Since it is clear that Congress did not in fact incorporate the rules of Sections 27(d), (e), (f) and (i) of the 1939 Code into section 316, Petitioners' interpretation is the only reasonable one.

Second, it is clear that Treas. Reg. § 1.562-1(a) does not substantially reflect the rule of old section 27(d). That statute provided that where a dividend is paid in property other than money, the amount to be used in computing the "basic surtax credit" would be the adjusted basis of the property *or* its fair market value, *whichever is the lower.*

[7] The "basic surtax credit" to which section 27(d) referred was comparable to the "deduction for dividends paid" in section 561 of the present Code.

The regulation, however, provides simply that such a dividend in kind will be measured, for purposes of the dividends paid deduction, only by the adjusted basis of the property, without regard to its fair market value.

These two rules will produce different results every time that a corporation distributes depreciated property for purposes of the dividends paid deduction. Under Treas. Reg. §1.562-1(a), if depreciated property is distributed as a dividend, the dividends paid deduction would equal the adjusted basis of such property. In contrast, the rule of section 27(d) would require that the fair market value, which is lower than the basis, be used to determine the deduction.

In summary, it is submitted that Congress did not intend to perpetuate the old valuation rule of the 1939 Code. Furthermore, it is clear that the regulation in question does not reflect that rule. Thus, section 27(d) cannot be used to support the regulation.

2. *Code section 312 cannot support Regulation §1.562-1(a) because it is irrelevant to the subject matter of that Regulation.*

In upholding the validity of the Regulation, the First Circuit also accepted the argument that section 312 of the Code is most relevant in determining the amount of the dividends paid deduction when property has been distributed.[8] This argument, however, is fallacious, for sec-

[8] The portion of section 312 which is relied upon reads as follows:

> SEC. 312. EFFECT ON EARNINGS AND PROFITS.
>
> (a) GENERAL RULE—Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of
>
> (1) the amount of money,
>
> (2) the principal amount of the obligations of such corporation, and
>
> (3) the adjusted basis of the other property,
>
> so distributed.

tion 312 has no bearing whatsoever upon taxation at the corporate level.

Section 312 merely deals with the bookkeeping adjustment which is made to the earnings and profits account of a corporation when it distributes property to shareholders. It sets forth the procedure for adjusting that account which limits the amount of a distribution which may be treated as a dividend. Section 316 states that, as a general rule, a distribution to which section 301 applies can only be a dividend to the extent that it is out of corporate earnings and profits. Thus, if the earnings and profits account is not large enough to cover the distribution, only a part of the distribution will be a dividend, and taxable as ordinary income under section 301(c)(1). Section 312 has no relevance at all to the question of whether a distribution is a taxable event at the corporate level; in fact, section 312 does not govern the determination of whether a distribution is a taxable event at any level — whether corporate or individual. Instead, section 311 governs this question at the corporate level, and section 301 governs this question at the shareholder level. The only relevance then of section 312 is to the question of how a particular corporate distribution is to be taxed to a shareholder under section 301(c), i.e. whether he must treat it as a dividend, a reduction of basis, or capital gain.

The opinion of the First Circuit is based on the erroneous assumption that the definition of the term "dividend" varies with its context. On the contrary the concept of a "dividend" is unitary and consistent. "Dividend" is a term of art which does not take on different meanings if its reference changes from corporations to shareholders. A dividend (section 316) is a distribution (section 301) out of earnings and profits (section 312). That is a unitary definition, of which section 312 is but a part. Its

meaning is intended to be consistent whether in the context of shareholder taxation or corporate taxation.

In summary, Treas. Reg. § 1.562-1(a) is not authorized either by any provisions of the Code, or by any of the legislative history surrounding the drafting of the Code. Furthermore, no statutory support for this regulation under prior revenue acts can be found. The regulation is the result of an arbitrary exercise of administrative regulation-making power.[9]

B. *The Regulation Leads to Results Which Are Inconsistent with the Purpose of the Statute.*

As indicated above, the purpose of both the personal holding company tax and the accumulated earnings tax is to insure taxation at the shareholder level by inducing corporations to make distributions of their after-tax income to shareholders. Individual shareholders must then include in their income the cash received as well as property received to the extent of its fair market value.

In light of the statutory purpose, it is easily demonstrated that the rule advanced by the Government leads to inconsistent and irrational results. The Commissioner's regulation creates a loophole for corporations and their stockholders, permitting them to escape the full impact of these taxes. For, if the amount of the dividends paid deduction is equal to the adjusted basis of the property distribu-

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[9] Several commentators have questioned the regulation. *See* Montgomery's FEDERAL TAXES, at 20.97 (39th ed. 1964). Another commentator, writing subsequent to the *Wetter* decision, also concluded that the regulation produced an improper result. *See* Nicholson, 114-2nd T.M., *Personal Holding Companies (Domestic) —Taxation and Relief*, at A8 and A9. *See also*, Rabkin & Johnson, FEDERAL INCOME, GIFT AND ESTATE TAXATION, Sec. 17.11 at 1765-66 (1977); Broenen & Preston, *Undistributed PHC Income: The Sixth Circuit in H. Wetter Mfg. Co. is Historically Sound*, 2 J. CORP. TAXATION 69 (1975).

ted, a corporation which holds depreciated property could distribute it as a dividend and claim the higher adjusted basis for its deduction, while the shareholders would be taxed only to the extent of the property's lower fair market value. In this manner, a tax on less than the amount of the personal holding company income would be levied on the individual stockholders. This is precisely the result that would be occasioned by Treas. Reg. § 1.562-1(a), and it is a result which is wholly inconsistent with the Congressional purpose in enacting the accumulated earnings tax and the personal holding company tax.

This inconsistency can be well illustrated by an example. If a personal holding company with undistributed personal holding company income of $100,000 were to distribute securities with a basis of $100,000 and a fair market value of $50,000, the individual shareholders would include in their income only $50,000, the fair market value of the securities at the time of distribution, while the corporation would be allowed a dividends paid deduction of $100,000, the adjusted basis of the securities in its hands. Thus, the corporation would be able to avoid the personal holding company tax entirely under the Commissioner's regulation even though the shareholders would not pay tax on the full amount of the corporation's undistributed personal holding company income. The regulation thus creates a loophole which is totally at odds with the purpose of the tax and could seriously undermine its effectiveness.

This anomalous result was avoided by the courts in several cases which interpreted the personal holding company tax as it existed in 1934. As it affects this discussion, that version of the personal holding company tax was no different from the way it appears today. In the case of *General Securities Co.* v. *Commissioner*, 42 B.T.A. 754 (1940), *aff'd* 123 F.2d 192 (10th Cir. 1941), the taxpayer, a personal holding company, distributed to its shareholders

depreciated property having a fair market value of $1,068.33 and a basis of $110,564.64. The taxpayer claimed a dividends paid deduction equal to the basis of the property distributed. The Board of Tax Appeals, in a decision which was affirmed by the Tenth Circuit, held that:

> We think that the Congressional reports from which we have quoted show that it was the intent of Congress that a personal holding company coming within the provisions of the act should receive a deduction against its "adjusted net income" for "dividends paid" of an amount equal to the amount of such dividends taxable to the stockholders. If this were not true, petitioner would receive a deduction for dividends paid of $103,898.17, which would be taxable to the stockholders only to the extent of $1,068.33. This result, we think, would be contrary to the intent of Congress. 42 B.T.A. at 758.

Accord, Foley Securities Co. v. *Commissioner*, 38 B.T.A. 1036 (1938), *aff'd*, 106 F.2d 731 (8th Cir. 1939).

The courts deciding *General Securities*, in holding that the proper valuation of an in-kind dividend for the purposes of the dividends paid deduction is the fair market value of the property, recognized that the purpose and structure of the personal holding company tax required that the amount of the deduction equal the amount taxable to the shareholders. Congress likewise recognized and carried out this purpose in the statutory provisions which were enacted as part of the 1954 Code.

In *General Securities*, the taxpayer urged the rule adopted by the Government in Treas. Reg. §1.562-1(a). This rule was rejected by the courts. Petitioners submit that this rule should be rejected again.

Conclusion

For the reasons stated above, Petitioners respectfully submit that the judgment of the Court below should be reversed.

DANIEL D. LEVENSON
LESLIE CRANE SLAVIN
One State Street
Boston, Massachusetts 02109
(617) 742-6720
Attorneys for Petitioners

Of Counsel:
LOURIE & CUTLER
One State Street
Boston, Mass. 02109

APPENDIX

Statutory Provisions Involved

INTERNAL REVENUE CODE OF 1954, AS AMENDED, UNITED STATES CODE, TITLE 26

Sec. 531. Imposition of Accumulated Earnings Tax.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the accumulated taxable income (as defined in section 535) of every corporation described in section 532, an accumulated earnings tax equal to the sum of—

(1) 27½ percent of the accumulated taxable income not in excess of $100,000, plus

(2) 38½ percent of the accumulated taxable income in excess of $100,000.

Sec. 535. Accumulated Taxable Income.

(a) DEFINITION.—For purposes of this subtitle, the term "accumulated taxable income" means the taxable income, adjusted in the manner provided in subsection (b), minus the sum of the dividends paid deduction (as defined in section 561) and the accumulated earnings credit (as defined in subsection (c)).

• • • •

(c) ACCUMULATED EARNINGS CREDIT.—

(1) GENERAL RULE.—For purposes of subsection (a), in the case of a corporation other than a mere holding or investment company the accumulated earnings credit is (A) an amount equal to such part of the earnings and profits for the taxable year as are retained for the reasonable needs of the business, minus (B) the deduction allowed by subsection (b)(6). For purposes of this paragraph, the

amount of the earnings and profits for the taxable year which are retained is the amount by which the earnings and profits for the taxable year exceed the dividends paid deduction (as defined in section 561) for such year.

• • • •

Sec. 541. Imposition of Personal Holding Company Tax.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to 70 percent of the undistributed personal holding company income.

Sec. 545. Undistributed Personal Holding Company Income.

(a) DEFINITION.—For purposes of this part, the term "undistributed personal holding company income", means the taxable income of a personal holding company adjusted in the manner provided in subsections (b), (c), and (d), minus the dividends paid deduction as defined in section 561. In the case of a personal holding company which is a foreign corporation, not more than 10 percent in value of the outstanding stock of which is owned (within the meaning of section 958(a)) during the last half of the taxable year by United States persons, the term "undistributed personal holding company income" means the amount determined by multiplying the undistributed personal holding company income (determined without regard to this sentence) by the percentage in value of its outstanding stock which is the greatest percentage in value of its outstanding stock so owned by United States persons on any one day during such period.

• • • •

Sec. 547. Deduction for Deficiency Dividends.

(a) GENERAL RULE.—If a determination (as defined in subsection (c)) with respect to a taxpayer establishes liability for personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law) for any taxable year, a deduction shall be allowed to the taxpayer for the amount of deficiency dividends (as defined in subsection (d)) for the purpose of determining the personal holding company tax for such year, but not for the purpose of determining interest, additional amounts, or assessable penalties computed with respect to such personal holding company tax.

• • • •

(d) DEFICIENCY DIVIDENDS.—

(1) DEFINITION.—For purposes of this section, the term "deficiency dividends" means the amount of the dividends paid by the corporation on or after the date of the determination and before filing claim under subsection (e), which would have been includible in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if distributed during such taxable year. No dividends shall be considered as deficiency dividends for purposes of subsection (a) unless distributed within 90 days after the determination.

(2) EFFECT ON DIVIDENDS PAID DEDUCTION.—

(A) FOR TAXABLE YEAR IN WHICH PAID.—Deficiency dividends paid in any taxable year (to the extent of the portion thereof taken into account under subsection (a) in determining personal holding company tax) shall not be included in the amount of dividends paid for such year for purposes of computing the dividends paid deduction for such year and succeeding years.

(B) FOR PRIOR TAXABLE YEAR.—Deficiency dividends paid in any taxable year (to the extent of the portion thereof taken into account under subsection (a) in determining personal holding company tax) shall not be allowed for purposes of section 563(b) in the computation of the dividends paid deduction for the taxable year preceding the taxable year in which paid.

• • • •

Sec. 561. Definition of Deduction for Dividends Paid.

(a) GENERAL RULE.—The deduction for dividends paid shall be the sum of—

(1) the dividends paid during the taxable year,

(2) the consent dividends for the taxable year (determined under section 565), and

(3) in the case of a personal holding company, the dividend carryover described in section 564.

(b) SPECIAL RULES APPLICABLE.—In determining the deduction for dividends paid, the rules provided in section 562 (relating to rules applicable in determining dividends eligible for dividends paid deduction) and section 563 (relating to dividends paid after the close of the taxable year) shall be applicable.

Sec. 562. Rules Applicable in Determining Dividends Eligible for Dividends Paid Deduction.

(a) GENERAL RULE.—For purposes of this part, the term "dividend" shall, except as otherwise provided in this section, include only dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions).

• • • •

Sec. 301. Distributions of Property.

(a) IN GENERAL.—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) AMOUNT DISTRIBUTED.—

(1) GENERAL RULE.—For purposes of this section, the amount of any distribution shall be—

(A) NONCORPORATE DISTRIBUTEES.—If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) CORPORATE DISTRIBUTEES.—If the shareholder is a corporation, unless subparagraph (D) applies, the amount of money received, plus whichever of the following is the lesser:

(i) the fair market value of the other property received; or

(ii) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b), (c), or (d) of section 311, under section 341(f), or under section 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a).

• • • •

(3) DETERMINATION OF FAIR MARKET VALUE.—For purposes of this section, fair market value shall be determined as of the date of the distribution.

(c) AMOUNT TAXABLE.—In the case of a distribution to which subsection (a) applies—

(1) AMOUNT CONSTITUTING DIVIDEND.—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

(2) AMOUNT APPLIED AGAINST BASIS.—That portion of the distribution which is not a dividend shall be applied against and reduce the adjusted basis of the stock.

(3) AMOUNT IN EXCESS OF BASIS.—

(A) IN GENERAL.—Except as provided in subparagraph (B), that portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

(B) DISTRIBUTIONS OUT OF INCREASE IN VALUE ACCRUED BEFORE MARCH 1, 1913.—That portion of the distribution which is not a dividend, to the extent that it exceeds the adjusted basis of the stock and to the extent that it is out of increase in value accrued before March 1, 1913, shall be exempt from tax.

(d) BASIS.—The basis of property received in a distribution to which subsection (a) applies shall be—

(1) NONCORPORATE DISTRIBUTEES.—If the shareholder is not a corporation, the fair market value of such property.

(2) CORPORATE DISTRIBUTEES.—If the shareholder is a corporation, unless subparagraph (3) applies, whichever of the following is the lesser:

(A) the fair market value of such property; or

(B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property, increased in the amount of gain to the distributing corporation which is recognized under section (b), (c), or (d) of section 311, under section 341(f), or under section 617(d)(1), 1245(a), 1250(a), 1251(c), 1252(a), or 1254(a).

• • • •

Sec. 312. Effect on Earnings and Profits.

(a) GENERAL RULE.—Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of—

(1) the amount of money,

(2) the principal amount of the obligations of such corporation, and

(3) the adjusted basis of the other property,

so distributed.

• • • •

Sec. 316. Dividend Defined.

(a) GENERAL RULE.—For the purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of its earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

(b) SPECIAL RULES.—

• • • •

(2) DISTRIBUTIONS BY PERSONAL HOLDING COMPANIES.—

(A) In the case of a corporation which—

(i) under the law applicable to the taxable year in which the distribution is made, is a personal holding company (as defined in section 542), or

(ii) for the taxable year in respect of which the distribution is made under section 563(b) (relating to dividends paid after the close of the taxable year), or section 547 (relating to deficiency dividends), or the corresponding provisions of prior law, is a personal holding company under the law applicable to such taxable year,

the term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) made by the corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 without regard to distributions under this paragraph) for such year.

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Supreme Court, U. S.
FILED
OCT 4 1977
MICHAEL RODAK, JR., CLERK

No. 76-1137

In the Supreme Court of the United States

OCTOBER TERM, 1977

ARTHUR FULMAN, ET AL., TRUSTEES, PETITIONERS

v.

UNITED STATES OF AMERICA

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

BRIEF FOR THE UNITED STATES

DANIEL M. FRIEDMAN,
Acting Solicitor General,

M. CARR FERGUSON,
Assistant Attorney General,

STUART A. SMITH,
Assistant to the Solicitor General,

MICHAEL L. PAUP,
JOSEPH L. LIEGL,
Attorneys,
Department of Justice,
Washington, D.C. 20530.

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BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The memorandum and order of the district court (Pet. App. B, pp. 18-24) are reported at 407 F. Supp. 1039.[1] The opinion of the court of appeals (Pet. App. A, pp. 8-17) is reported at 545 F.2d 268.

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[1] The district court subsequently amended footnote 5 of its memorandum and order (see A. 28).

JURISDICTION

The judgment of the court of appeals was entered on November 19, 1976 (A. 4). The petition for a writ of certiorari was filed on February 17, 1977, and was granted on May 23, 1977 (A. 5). The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTION PRESENTED

Section 541 of the Internal Revenue Code of 1954 imposes a special tax, in addition to the corporate income tax, on a corporation that is a personal holding company and has "undistributed personal holding company income." Sections 545 and 561 allow a deduction from undistributed personal holding company income for dividends paid.

The question presented is whether a personal holding company's distribution of appreciated property to its shareholders results in a deduction for dividends paid from its undistributed personal holding company income equal to the corporation's tax basis in the distributed property, as the court of appeals held, or the fair market value of the property at the time of the distribution, as petitioners contend.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of Sections 301, 312, 316, 541, 542, 545, 547, 561 and 562 of the Internal Revenue Code of 1954, as amended (26 U.S.C.), and the Treasury Regulations on Income Tax, Section 1.562-1 (a) (26 C.F.R.), are set forth in the Appendix, *infra*, pp. 1a-15a.

STATEMENT

1. Petitioners are the successors to, and transferees of assets of, Pierce Investment Company ("Pierce"). On audit, the Commissioner of Internal Revenue determined that Pierce was a personal holding company, as defined by Section 542(a) of the Internal Revenue Code of 1954, for 1959, 1960, 1962 and 1963, and determined deficiencies in personal holding company taxes of $26,571.30 (Pet. App. A, pp. 9-10; A. 17).

Pursuant to the deficiency dividend procedure provided by Section 547 of the Code, Pierce executed a written agreement with the Commissioner in which it conceded its personal holding company status and consented to the Commissioner's determination of personal holding company taxes. Within 90 days after it executed this agreement, Pierce distributed to its shareholders shares of stock that it held in other corporations. Pierce's tax basis in these shares was $18,725.11, and at the time of distribution they had a fair market value of $32,535.[2] Thereafter, Pierce filed a claim under Section 547 of the Code for a deficiency-dividends deduction of $32,535, the fair market value of the stock it distributed to its shareholders (Pet. App. A, pp. 9-10; A. 8-13, 18).

Pursuant to Section 1.562-1(a) of the Treasury Regulations on Income Tax (26 C.F.R.), the Commissioner allowed the claimed deficiency-dividends deduction from "undistributed personal holding com-

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[2] At the time of the distribution, Pierce had accumulated earnings and profits of $42,096.76 (A. 12).

pany income" only to the extent of Pierce's adjusted basis in the distributed securities, *i.e.*, $18,725.11. He then determined deficiencies in personal holding company taxes with respect to Pierce's personal holding company income that remained undistributed. Pierce paid the tax and the Commissioner denied its claims for refund (Pet. App. A, p. 10; A. 18-19).

2. In this refund suit brought by petitioners in the United States District Court for the District of Massachusetts,[3] the district court upheld the validity of the governing Treasury Regulations that provide that a personal holding company's distribution of appreciated property to its shareholders results in a dividends-paid deduction from its undistributed personal holding company income equal to its basis in the distributed property. It accordingly ruled that Pierce could claim a deficiency-dividends deduction only to the extent of its adjusted basis in the distributed stock. The court relied upon the legislative history of Section 562 of the 1954 Code, which evidenced Congress' intention to carry forward from the 1939 Code a rule similar to that of the Regulation limiting the dividends-paid deduction in the case of a non-cash distribution to the personal holding company's adjusted basis in the distributed property (Pet. App. B, pp. 18-24).

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[3] Pierce was liquidated after this suit was initiated, and petitioners were substituted as plaintiffs (A. 25). For convenience, we use the term "petitioner" to refer to Pierce Investment Company.

The court of appeals unanimously affirmed (Pet. App. A, pp. 8-17). Like the district court, it upheld the validity of the governing Treasury Regulation as a reasonable interpretation of the personal holding company tax statute, and refused to follow the contrary decision in *H. Wetter Manufacturing Co.* v. *United States*, 458 F.2d 1033 (C.A. 6). The court of appeals observed that the legislative history of Section 562 of the 1954 Code confirmed that Congress intended to preserve the dividend valuation rule of Section 27(d) of the 1939 Code (26 U.S.C. (1952 ed.)), which had provided that the upper limit on a deduction for dividends paid in kind was the corporation's adjusted basis in the distributed property (Pet. App. A, pp. 11-12).

The court further noted that its ruling was consistent with Section 312 of the 1954 Code, which provides that a dividend that is paid in property will reduce a corporation's earnings and profits only to the extent of the corporation's adjusted basis in the property (Pet. App. A, pp. 13-14). Accordingly, the court rejected petitioner's (and the Sixth Circuit's) reliance on Section 301(b)(1) of the Code, which provides that the "amount distributed" to a non-corporate recipient of a corporate distribution is the fair market value of the property. In the court of appeals' view, that provision was not relevant in determining the amount of a personal holding company's dividends-paid deduction.

Finally, the court of appeals concluded that the adjusted-basis rule of the Regulations was in accord

with the purpose of the personal holding company tax to compel the distribution of passive investment income to the shareholders of such a corporation. As the court observed, if a personal holding company could distribute appreciated property to its shareholders and claim a dividends-paid deduction equal to the fair market value of the property, it could shield passive investment income from the personal holding company tax (Pet. App. A, pp. 15-16).

SUMMARY OF ARGUMENT

A.

Since 1934, Congress has provided for a special tax on personal holding companies in order to prevent high-bracket individuals from exploiting the lower tax rates on corporations. The tax is imposed on the "undistributed personal holding company income" of such corporations, which is generally passive investment income such as dividends, rents, and interest.

Once the Commissioner determines that a corporation is liable for the personal holding company tax, the corporation may avoid the tax by distributing its personal holding company income to its shareholders. Such distributions give rise to a "dividends-paid deduction," which reduces the undistributed personal holding company income to which the tax applies. The personal holding company tax is intended to compel the distribution of realized passive investment income to shareholders in the form of taxable dividends.

The question presented here concerns the computation of the dividends-paid deduction when a personal holding company distributes appreciated propery rather than cash to its shareholders. Petitioners claim a dividends-paid deduction equal to the fair market value of the appreciated property. However, the courts below upheld the government's position, set forth in Treasury Regulations on Income Tax, Section 1.562-1(a), that the dividends-paid deduction with respect to such non-cash distributions is limited to the distributing corporation's cost basis in the property.

The limitation on the dividends-paid deduction provided by Section 1.562-1(a) of the Regulations is both reasonable and consistent with the statutory scheme. The personal holding company tax is intended to prevent the tax avoidance that would result if realized investment income that would otherwise be taxable at progressive rates applicable to individuals could be accumulated at the corporate level. The net effect of the tax is to induce personal holding companies to distribute all of their passive investment income to the shareholders, or risk imposition of the penalty tax.

If a corporation could distribute appreciated property to its shareholders and claim a dividends-paid deduction equal to the fair market value of the property, it could retain part of its passive investment income and nevertheless avoid the personal holding company tax on such income. Section 1.562-1(a) of the Regulations therefore provides that the dividends-

paid deduction is limited to the corporation's basis in distributed property, *i.e.*, the amount of corporate earnings actually invested in the distributed property. Since the Regulation is consistent with the objectives of the personal holding company tax, the court of appeals correctly upheld its validity. See, *e.g.*, *Bingler* v. *Johnson*, 394 U.S. 741; *Commissioner* v. *South Texas Co.*, 333 U.S. 496.

Moreover, as the court of appeals correctly observed (Pet. App. A, pp. 11-14), the pertinent legislative history supports the Regulation. Section 27(d) of the Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)) provided that the upper limit on the deduction for a dividend paid in kind was the corporation's adjusted basis in the distributed property. While Congress did not include Section 27(d) in the 1954 Code, the Senate Finance Committee Report with respect to Section 562(a), which specifies the dividends to which the dividends-paid deduction applies, indicates that the rule of Section 27(d) was to be carried over into the 1954 revision. The Committee Report stated that "[t]he requirements of section[] 27(d) * * * of existing law are contained in the definition of 'dividend' in section 312, and accordingly are not restated in section 562." S. Rep. No. 1622, 83d Cong., 2d Sess. 325 (1954). While Section 312 does not explicitly address the question of the amount of the dividends-paid deduction, the Commissioner's Regulation implements the clearly-stated legislative history showing that Congress intended to

preserve the adjusted-basis rule of Section 27(d) of the 1939 Code.

Petitioners' theory that personal holding companies are entitled to a dividends-paid deduction equal to the fair market value of property distributed in kind at the time of the distribution would permit those companies to accumulate passive investment income and shelter it from the personal holding company tax by distributing appreciated property to its shareholders. As the court of appeals pointed out (Pet. App. A, pp. 16-17), acceptance of petitioners' argument would lead to disparate treatment of personal holding companies that had equal amounts of personal holding company income but invested their income in property that appreciated at different rates.

B.

Section 301(b), which requires a non-corporate distributee who receives corporate property to include such property for income tax purposes at fair market value, does not support the fair market rule for the dividends-paid deduction urged by petitioners. The language and legislative history of that provision show that it is addressed solely to the amount of a corporate distribution that the recipient shareholder is required to include in income. There is no necessary correspondence between that amount and the amount of the dividends-paid deduction to which a personal holding company is entitled. Indeed, prior to the 1954 Code, the statute contained both the basis rule for the dividends-paid deduction, now set

forth in the Treasury Regulations, and the requirement that a shareholder report as income the fair market value of property received in a corporate distribution. *H. Wetter Manufacturing Co.* v. *United States*, 458 F.2d 1033 (C.A. 6), which likewise relied upon Section 301, was therefore incorrectly decided.

Contrary to petitioners' further argument, *Ivan Allen Co.* v. *United States*, 422 U.S. 617, does not cast doubt upon the validity of the Treasury Regulation at issue in this case. There, the Court held that the net liquidation value, rather than the cost basis, of marketable securities owned by a corporation had to be taken into account in determining whether the corporation had accumulated earnings and profits beyond the reasonable needs of its business. But in so concluding, the Court emphasized that the unrealized appreciation of the securities was not included in accumulated taxable income, the base upon which the tax was imposed. However, the unrealized appreciation was relevant in appraising whether the corporation had accumulated realized earnings in excess of its reasonable business needs.

Here, on the other hand, the personal holding company tax does not contemplate the inquiry whether a corporation has accumulated earnings beyond a particular amount. The personal holding company tax base is measured entirely by realized items of income less actual disbursements. To give petitioners a dividends-paid deduction equal to the fair market value of appreciated property would distort the personal holding company tax base by introducing an

element of unrealized appreciation on the deduction side while eliminating the same element on the income side. Such an imbalance is contrary to the *Ivan Allen Co.* rationale.

ARGUMENT

A PERSONAL HOLDING COMPANY'S DISTRIBUTION OF APPRECIATED PROPERTY TO ITS SHAREHOLDERS RESULTS IN A DIVIDENDS-PAID DEDUCTION EQUAL TO ITS ADJUSTED BASIS IN THE DISTRIBUTED PROPERTY

A. Introduction

This federal income tax case presents a technical question with respect to which there is a conflict in the circuits concerning the computation of the dividends-paid deduction under the personal holding company tax imposed by Section 541 of the Internal Revenue Code of 1954.

The marginal tax rate applicable to corporations is substantially lower than that applicable to individuals.[4] In the absence of a statutory corrective, the differential between corporate and individual tax rates would permit high-bracket individual taxpayers to transfer passive investment property to a closely-held corporation, accumulate the income, and then sell or liquidate the corporation at capital gains rates,

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[4] Corporate income is subject to a 22 percent tax on the first $25,000 of taxable income and a 48 percent tax on taxable income in excess of $25,000. See Section 11 of the Internal Revenue Code of 1954. The tax rates applicable to individual income range from 14 percent to 70 percent. See Section 1 of the Code.

thereby achieving a lower net tax than if they had held the property outright.

Since 1934, the personal holding company tax has supplied the necessary corrective. It is a special tax, imposed in addition to the ordinary corporate income tax, on the income from passive investments that has been accumulated by a "personal holding company."

The tax is chiefly aimed at closely-held, investment corporations. Section 542(a) defines a "personal holding company" as a corporation, more than 50 percent of whose stock is owned, actually or constructively, by five or fewer individuals. In order to be classified as a personal holding company, at least 60 percent of the corporation's adjusted ordinary gross income for the year must constitute "personal holding company income," which Section 543(a) defines primarily as passive investment income, such as dividends, rents, and interest.[5] When it applies, the personal holding company tax is 70 percent of the corporation's undistributed personal holding company income.[6]

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[5] During 1962 and 1963, the years at issue here, a corporation became subject to the personal-holding tax only if 80 percent of its "adjusted ordinary gross income" constituted personal-holding-company income. In the Revenue Act of 1964, Section 225, 78 Stat. 79, Congress lowered the income threshold to 60 percent.

[6] During the years in issue, the tax imposed by Section 541 was 75 percent of the first $2,000 of undistributed personal holding income and 85 percent of any additional amounts. In the Revenue Act of 1964, Section 225, 78 Stat. 79, Congress reduced the tax to a flat rate of 70 percent. Neither this change nor any of the other changes made by the Revenue Act of 1964 have any relevance to the question in this case.

If a corporation meets the definition of a personal holding company and has personal holding company income, it does not automatically have to pay the personal holding company tax. From the inception of the tax, Congress has provided a "last chance" mechanism by which a corporation can avoid the personal holding company tax even after the Commissioner's determination of a deficiency. As a leading text has observed, "[b]ecause the prime purpose of the personal holding company tax is not to raise revenue but to force such corporations to distribute earnings to their shareholders (in whose hands the distributed earnings will be subject to the graduated income tax), and in recognition of the tax's virtually confiscatory rate, the Internal Revenue Code provides a locus poenitentiae in the form of the 'deficiency dividend' procedure." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 8.20, p. 8-35 (3d ed., 1971).

Under this deficiency dividend procedure, once the Commissioner determines that a corporation is liable for the personal holding company tax, the corporation may avoid the tax by distributing its personal holding company income to its shareholders. Such distributions give rise to a "dividends paid deduction" that reduces the amount of undistributed personal holding company income to which the tax applies. See Sections 541, 545, 547, and 561 of the Code.

Thus, the personal holding company tax is an inducement to the distribution of realized passive investment income to the shareholders in the form of taxable dividends.

The question presented in this case concerns the computation of the dividends-paid deduction from undistributed personal holding company income when a personal holding company distributes property rather than cash to its shareholders. It was stipulated that Pierce was a personal holding company for the years at issue and that it was liable for approximately $26,000 in personal holding company taxes upon personal holding company income it had realized but not distributed during those years (see A. 10-11, 17-18). To avoid that liability, Pierce made a dividend distribution to its shareholders of stock that had appreciated in value in its hands (from its cost of $18,000 to its then fair market value of $32,000), and thereafter claimed a dividends-paid deduction equal to the fair market value of the stock. However, the courts below sustained the government's position, set forth in Treasury Regulations on Income Tax, Section 1.562-1(a), Appendix, *infra*, pp. 14a-15a, that the dividends-paid deduction for such non-cash distributions is limited to the corporation's basis in the property (its cost of $18,000).[7]

We submit that the decision below correctly upheld the limitation on the dividends-paid deduction provided by Section 1.562-1(a) of the Regulations as

[7] "Basis" generally constitutes the cost of the property. See Section 1012 of the Code.

both reasonable and consistent with the statutory scheme. The personal holding company tax is intended to compel personal holding companies to distribute all of their passive investment income to their shareholders. But if a corporation could distribute appreciated property and claim a dividends-paid deduction from its accumulated passive investment income equal to the fair market value of the property, it could retain part of that income and nevertheless avoid the personal holding company tax on such income.

The Regulation therefore provides that the dividends-paid deduction is limited to the corporation's basis in distributed property, *i.e.*, the amount of corporate earnings actually invested in that property. Moreover, it is consistent with the general tax treatment of corporate distributions of property other than cash. Finally, as we shall show, the Regulation is supported by the pertinent legislative history of the 1954 Code, which indicates that Congress intended to preserve an essentially similar rule under the 1939 Code.

B. The Commissioner's Regulation Limiting The Dividends-Paid Deduction To The Cost Basis Of Distributed Property Implements Congress' Intention To Compel Personal Holding Companies To Distribute Personal Holding Company Income To Their Shareholders

1. *The Statutory History*

a. Since the beginning of the modern income tax, Congress has employed various methods for preventing individuals from using corporations to shield their

personal income from the higher graduated rates applicable to individuals. Section IIA(2) of the Tariff Act of 1913, 38 Stat. 166, the first income tax statute following the adoption of the Sixteenth Amendment, imposed a tax on individual shareholders for their pro rata shares of the earnings of a corporation "formed or fraudulently availed of for the purpose of preventing the imposition of" the tax on individuals "through the medium of permitting * * * gains and profits to accumulate instead of being divided or distributed * * *." This tax continued in much the same form until 1921, when the incidence of the tax was shifted from the shareholder to the corporation. See Section 220 of the Revenue Act of 1921, 42 Stat. 247; *United States* v. *Donruss Co.*, 393 U.S. 297, 303-307.

Under the early versions of this accumulated earnings tax, the Commissioner had to prove that a corporation had accumulated earnings in order to shield its shareholders from income taxes. The difficulty of demonstrating such a purpose rendered the tax virtually ineffective as a deterrent against corporate accumulations. *Commissioner* v. *Lane-Wells Co.*, 321 U.S. 219, 221; see Preliminary Report of a Subcommittee of the House Committee on Ways and Means, *Prevention of Tax Avoidance*, 73d Cong., 2d Sess. 7 (1933). Various measures were proposed to remedy the situation.

In studying these proposals, Congress focused on one class of corporations that was notorious for its use of corporate accumulations to shield shareholders

from the graduated tax, the so-called "incorporated pocketbook." These corporations were generally formed to hold a high-income individual's investment properties or receive the income from his services and to retain the resulting earnings. The income earned from the passive investment activities was realized by the corporation, taxed at the lower corporate rates and accumulated at the corporate level to avoid tax at the higher rates applicable to the individual shareholder. See Preliminary Report, *Prevention of Tax Avoidance*, *supra*, at 6-8. See also *Commissioner* v. *Laughton*, 113 F.2d 103 (C.A. 9).

In 1934, Congress took direct action against these incorporated pocketbooks. It exempted them from the accumulated earnings tax and imposed, in addition to the corporate income tax, a special tax on the "undistributed" income of such "personal holding companies." Revenue Act of 1934, Sections 102 and 351, 48 Stat. 702-703, 751-752.[8] The new tax was designed to apply automatically to any corporation coming within its definitional provisions with respect to number of shareholders and type of income. Un-

[8] As early as 1928, proposals had been made for legislation addressed to the problem of such "personal holding companies" because of the difficulties in enforcing the accumulated earnings tax. See H.R. 1, 70th Cong., 1st Sess., Sections 104 and 105 (1927); H.R. Rep. No. 2, 70th Cong., 1st Sess. 17-18 (1927). However, at that time, the Senate Finance Committee concluded that the accumulated earnings tax adequately dealt with the problem of unreasonable accumulations (S. Rep. No. 960, 70th Cong., 1st Sess. 12 (1928)), and only those provisions were retained in the statute (H.R. Rep. No. 1882, 70th Cong., 1st Sess. 14 (1928).

der the personal holding company tax, corporations meeting the objective criteria set forth in the statute became liable for personal holding company taxes, whether or not it could be shown that the corporation had accumulated its earnings for the purpose of avoiding taxes. Thus, the personal holding company tax eliminated the problems of proof encountered by the Treasury in its enforcement of the accumulated earnings tax.[9] H.R. Rep. No. 704, 73d Cong., 2d Sess. 11-12 (1934); S. Rep. No. 558, 73d Cong., 2d Sess 13-16 (1934).

b. Since the primary purpose of the personal holding company tax is to force distributions of a personal holding company's passive investment income to its shareholders, the statutes have consistently provided that a corporation could reduce undistributed personal holding company income otherwise subject to the tax by dividends paid to shareholders.

The 1934 Act did not address the question presented in this case concerning the impact of a distribution of

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[9] In 1937 and 1964, Congress made major revisions of the personal holding company tax. These changes were intended to tighten its provisions against use of the incorporated pocketbook and to encompass other uses of the corporate form which Congress determined could be presumed to have been devised for the purpose of avoiding income tax on high-income individuals. See Report of the Joint Committee on Tax Evasion and Avoidance, *Tax Evasion and Tax Avoidance*, H.R. Doc. No. 337, 75th Cong., 1st Sess. (1937). Revenue Act of 1937, Section 1, 50 Stat. 813. See generally, Libin, *Personal Holding Companies and the Revenue Act of 1964*, 63 Mich. L. Rev. 421 (1965); Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶ 8.20 et seq. (3d ed., 1971).

property other than cash upon the computation of a personal holding company's "undistributed adjusted net income" that was made subject to the special tax. However, subsequent legislation soon filled the gap with respect to the effect of distributions of appreciated property upon the tax base by providing the very rule that is incorporated in the Commissioner's present Regulations.

In 1936, Congress enacted a surtax on undistributed profits (see Revenue Act of 1936, Section 14, 49 Stat. 1655), which likewise sought to discourage corporate accumulations designed to avoid the progressive individual income tax. See S. Rep. No. 2156, 74th Cong., 2d Sess. 5 (1936). The surtax on undistributed profits set forth specific rules with respect to the effect of various non-cash dividend distributions upon the tax base. Section 27(c) of the Revenue Act of 1936, 49 Stat. 1665, provided:

> If a dividend is paid in property other than money * * * the dividends paid credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

The Revenue Act of 1936 further provided that the rule of Section 27(c) also governed the computation of the dividends-paid credit available to personal holding companies (Section 351(b)(2)(C), 49 Stat. 1732), the allowance of the dividends-paid credit available in computing the accumulated earnings tax

(Section 102(c)(2), 49 Stat. 1677), and the determination of a mutual investment company's net income subject to the normal tax (Section 13(a)(3), 49 Stat. 1655).[10]

The critical fact that emerges from this early statutory history is that the 1936 Revenue Act explicitly provided that a personal holding company's dividends-paid credit for distributions in kind could not exceed its basis in the distributed property. By contrast, that same Revenue Act further provided a completely different measure for determining the amount includable in a shareholder's income with respect to such non-cash distributions. Under Section 115(j) of the Act, 49 Stat. 1689, distributions of property were includable in the shareholder's income at the fair market value of the property at the time of the distribution.

Until the 1954 codification, each subsequent tax statute reenacted without material change both the rule of Section 27(c), limiting the corporate deduction for non-cash dividends to the adjusted basis of the distributed property, and the requirement that the shareholders include in income the fair market value

[10] While the 1936 Act and subsequent statutes referred to the adjustment for dividends paid as a "credit," the effect of the adjustment has always been the equivalent of what is now commonly characterized as a deduction, *i.e.*, the reduction of the income base upon which the tax is computed, rather than as a credit, *i.e.*, direct reduction of the tax liability itself. However, the 1954 Code characterizes the dividends paid adjustment as a "deduction." See Internal Revenue Code of 1954, Sections 561, 562, 535(a), 545(a), and 556(a).

of the distributed property.[11] Moreover, Congress extended the application of the rule of Section 27(c)[12] to the provisions dealing with the taxation of foreign personal holding companies. See Section 201 of the 1937 Act, 50 Stat. 818.

In sum, it is undisputed that from 1936 to 1954, the tax statutes uniformly provided that a non-cash dividend by a personal holding company could not reduce its undistributed personal holding company income by more than the corporation's cost basis in the distributed property. This basis limitation applied even though, under those same statutes, the recipient shareholders were required to include in their income the full fair market value of the property at the time of its distribution.

2. *The 1954 Code*

a. When Congress enacted the Internal Revenue Code of 1954, it carried forward the dividends-paid deduction for personal holding companies in Section 561, Appendix, *infra*, p. 13a. That provision states that the deduction for dividends paid "shall be the sum of—(1) the dividends paid during the taxable year, [and] (2) the consent dividends for the taxable year (determined under section 565), * * *." In turn,

[11] See Sections 27(c) and 355 of the Revenue Act of 1936, as amended by Section 1 of the Revenue Act of 1937, 50 Stat. 813; Sections 27(d), 102 and 405 of the Revenue Act of 1938, 52 Stat. 469, 483, and 560; and Sections 27(d), 102 and 504 of the Internal Revenue Code of 1939 (26 U.S.C. (1952 ed.)).

[12] Section 27(c) of the Revenue Act of 1936 was reenacted as Section 27(d) in subsequent revenue acts.

Section 545 generally defines the term "undistributed personal holding company income" as the net passive investment income of a personal holding company "minus the dividends paid deduction as defined in section 561." [13]

The text of the 1954 Code does not explicitly contain any rule comparable to the limitation of Section 27(c) of the 1936 Act (thereafter Section 27(d) of the 1939 Code), which provided that in a non-cash distribution, the dividends-paid deduction was limited to the lesser of the corporation's adjusted basis in the property or its fair market value. Nevertheless, the legislative history of the 1954 Code shows that Congress intended to preserve the adjusted-basis limitation of the prior Code. In describing the purpose of Section 562(a), the Senate Finance Committee explained (S. Rep. No. 1622, 83d Cong., 2d Sess. 325 (1954); emphasis supplied):

> Subsection (a) provides that the term "dividend" for purposes of this part shall include, except as otherwise provided in this section, only those dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions). *The requirements of sections 27 (d), (e), (f), and (i) of existing law are contained in the definition of "dividend" in section 312, and accordingly are not restated in section 562.*

[13] Under the 1954 Code, the dividends-paid deduction provisions and the Regulations at issue here apply to personal holding companies (Section 545(a)), foreign personal holding companies (Section 556(a)), regulated investment companies (Section 852(b)), and to the accumulated earnings tax (Section 535(a)). In 1960, the dividends-paid deduction was also made applicable to the taxation of real estate investment trusts and their shareholders. See Section 857(b) of the Code, added by Section 10(a) of the Act of September 14, 1960, 74 Stat. 1003.

This committee report, which is virtually identical to that of the House Ways and Means Committee (H.R. Rep. No. 1337, 83d Cong., 2d Sess. A181 (1954)), demonstrates that the draftsmen of the 1954 Code intended to carry forward the adjusted basis rule of Section 27(d) of the 1939 Code. They accordingly concluded that it was unnecessary to restate the rule of Section 27(d) in Section 562 of the 1954 Code because it was already contained in the definition of dividend set forth in "section 312" of the new Code.[14]

There is nothing in Section 312 of the 1954 Code that explicitly incorporates the adjusted basis rule of Section 27(d) of the 1939 Code with respect to the dividends-paid deduction. But Section 312(a)(3) of the 1954 Code is closely analogous to Section 27(d) of the prior Code. Section 312(a)(3) provides that

[14] It is not entirely clear whether the Senate Report's reference to "section 312" intended to refer to Section 312 of the 1954 Code (dealing with earnings and profits) or to Section 312 in the House version of the 1954 Code. Section 312 of the House bill (which defined dividends) was modified by the Senate and, as modified, became Section 316 of the 1954 Code. See H.R. 8300, 83d Cong., 2d Sess. (1954). Although the court of appeals observed that a comparison of Section 312 of the 1954 Code with Section 27(d), (e), (f), and (i) suggests that the Senate Report may have had Section 312 of the *Code* in mind, it could not eliminate the inference that the reference to "section 312" as "defining" the term dividend may have been a typographical error (see Pet. App. A, p. 12 n. 2).

when a corporation distributes property to its shareholders as a dividend, its earnings and profits shall be decreased only by the adjusted basis of such property.[15] Section 27(d) of the 1939 Code similarly provided that a non-cash dividend distribution resulted in a dividends-paid deduction equal to the lesser of the adjusted basis or the fair market value of the property.

Finally, the legislative history of the 1954 Code contains further evidence that Congress intended to carry forward the rule of Section 27(d) of the 1939 Code. With respect to the taxation of regulated investment companies, the Senate Finance Committee stated that the tax treatment of regulated investment companies would be substantially the same as under Sections 361 and 362 of the 1939 Code. See S. Rep. No. 1622, *supra*, at 411. Since Section 362 of the 1939 Code expressly incorporated the adjusted basis rule of Section 27(d) of the 1939 Code, that rule is likewise applicable under the 1954 Code.

b. The foregoing legislative history of Section 562 of the 1954 Code shows that Congress intended to preserve the rule of Section 27(d) of the 1939 Code, which limited the dividends-paid deduction to an

[15] Likewise, Section 312(a)(2) provides that when a corporation distributes its own obligations as a dividend, its earnings and profits shall be reduced by the principal amount of the obligations. This rule is parallel to Section 27(e) of the 1939 Code, which provided that a corporation that distributed its obligations as a dividend, could claim a dividends-paid deduction from undistributed personal holding company income equal to the lesser of the face amount of the obligations or their fair market value.

amount equal to the adjusted basis of the distributed property. Both the House and Senate Committees responsible for reporting the 1954 codification of the tax law concluded that it was unnecessary to carry forward Section 27(d) verbatim in the new Code because "[t]he requirements of * * * [section] 27(d) * * * of existing law are incorporated in the definition of 'dividend' in section 312, and accordingly are not restated in section 562." H.R. Rep. No. 1337, *supra*, at A181; S. Rep. No. 1622, *supra*, at 325. Congress was therefore aware of the limitation of Section 27(d) and expressly approved its continued application under the 1954 Code.

The fact that the definition of "dividend" in the 1954 Code does not explicitly incorporate the dividends-paid deduction rule of Section 27(d) of the 1939 Code does not diminish the persuasive force of this legislative history. Under the settled principle of *United States* v. *Ryder*, 110 U.S. 729, 740, "[i]t will not be inferred that the legislature, in revising and consolidating the laws, intended to change their policy, unless such intention be clearly expressed." Accord: *Aberdeen & Rockfish R. Co.* v. *SCRAP*, 422 U.S. 289, 309 n. 12; *Muniz* v. *Hoffman*, 422 U.S. 454, 467-472. As the Court stated in *Fourco Glass Co.* v. *Transmirra Corp.*, 353 U.S. 222, 227, in terms that are particularly appropriate here, "no changes of law or policy are to be presumed from changes of language in the revision unless an intent to make such changes is clearly expressed."

Indeed, this case follows *a fortiori* from *Ryder*, for Congress was not silent during the 1954 revision but expressly stated its intention to preserve the dividends-paid deduction rule of Section 27(d) of the 1939 Code. Since there is nothing in the 1954 Code that abrogates the limitation of Section 27(d) and Congress undisputably intended to carry it forward, there is no basis to infer its repeal by implication. See, *e.g.*, *Regional Rail Reorganization Act Cases*, 419 U.S. 102, 133; *Mercantile National Bank* v. *Langdeau*, 371 U.S. 555, 565; *United States* v. *Borden Co.*, 308 U.S. 188, 198-199; *Amell* v. *United States*, 384 U.S. 158, 165-166.

Viewed in the context of these longstanding canons of statutory construction and the clear legislative history approving the rule of Section 27(d) of the prior law, the Commissioner's Regulation at issue in this case properly implements the intent of Congress. It is therefore hardly surprising that all of the courts that have passed upon the validity of the Regulations, including the courts that held them invalid, have agreed that the legislative history supports them. See Pet. App. A, pp. 11-12; Pet. App. B, pp. 23-24; *C. Blake McDowell, Inc.* v. *Commissioner*, 67 T.C. 1043, appeal docketed, C.A. 6, No. 77-1493; *H. Wetter Manufacturing Co.* v. *United States*, *supra*, 458 F.2d at 1035; *Gulf Inland Corp.* v. *United States*, 75-2 U.S.T.C. ¶ 9620, decided July 16, 1975 (W.D. La.), appeal pending, C.A. 5, No. 75-3767.

Like Section 27(d) of the prior Code, Section 1.562-1(a) of the Regulations limits the dividends-paid deduction to an amount equal to the adjusted basis of the distributed property. It provides:

> If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution.

The Regulation was promulgated shortly after the enactment of the 1954 Code [16] and therefore represents a contemporaneous construction of the provisions defining the dividends-paid deduction. "[T]his Court shows great deference to the interpretation given the statute by the officers or agency charged with its administration." *Udall* v. *Tallman*, 380 U.S. 1, 16. Indeed, this principle has been applied with particular frequency with respect to Treasury Regulations interpreting the Internal Revenue Code. As the Court observed in *Bingler* v. *Johnson*, 394 U.S. 741, 749-750, quoting from *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501, " it is fundamental * * * that as 'contemporaneous constructions by those charged with administration of' the Code, the Regulations 'must be sustained unless unreasonable and plainly inconsistent with the revenue statutes,' and 'should not be overruled except for weighty reasons.'" Accord: *United States* v. *Correll*, 389 U.S. 299, 306-307.

Finally, in enacting a major revision of the personal holding company tax in 1964 without altering the basis limitation rule with respect to non-cash dis-

[16] See T.D. 6308, 1958-2 Cum. Bull. 279.

tributions,[17] Congress must be deemed to have approved the Commissioner's consistent interpretation set forth in Section 1.562-1(a) of the Regulations. The Court frequently has held that "such a long-standing administrative interpretation, applying to a substantially reenacted statute, is deemed to have received congressional approval and has the effect of law." *Commissioner* v. *Noel Estate*, 380 U.S. 678, 682. Accord: *United States* v. *Correll*, *supra*, 389 U.S. at 305-306; *Helvering* v. *Winmill*, 305 U.S. 79, 83; *Fribourg Nav. Co.* v. *Commissioner*, 383 U.S. 272, 283. See also *Paragon Coal Co.* v. *Commissioner*, 380 U.S. 624, 635-636. Indeed, as we shall show, the Regulation promotes the statutory purpose of compelling personal holding company income.

c. The Regulations' adjusted basis rule is not only consonant with congressional intent, but also is in accord with the purpose of the personal holding company tax. As we indicated earlier, in the Revenue Act of 1936 Congress specifically adopted different measures for the dividends-paid credit allowable to a personal holding company for a distribution of appreciated property and the amount includable in the shareholder's income as a result of the distribution.

[17] See Revenue Act of 1964, Section 225, 78 Stat. 79. Congress also incorporated the dividends-paid deduction provisions into the provisions for taxation of real estate investment trusts enacted in 1960 (Act of September 14, 1960, Section 10(a), 74 Stat. 1003), and most recently substantially revised those provisions in the Tax Reform Act of 1976 (Pub. L. 94-455, Sections 1601-1607, 90 Stat. 1742-1757).

personal holding companies
to distribute all of their

Thus, the personal holding company tax was designed not only to prevent tax avoidance by inducing distributions that would result in taxable income to shareholders equal to the corporation's total undistributed personal holding company income. Congress went further, and permitted a personal holding company to avoid the special tax on undistributed income only to the extent that the distribution represented the company's realized earnings, *e.g.*, its basis in the distributed property.

To allow a corporation a dividends-paid deduction equal to the amount representing the income its shareholders realize from the distribution—normally the fair market value of the property distributed—would undercut the congressional design. By distributing appreciated property, a corporation could offset against its undistributed but realized income amounts that would largely represent unrealized appreciation. The corporation could thus avoid the personal holding company tax upon earnings from passive investment activities—the very type of income upon which the tax was intended to apply.

A simple example will illustrate the point. Assume that two corporations, A and B, are personal holding companies, each of which has realized and retained $1,000 of royalty income during the year. Under Section 545(a) of the Code, this $1,000 constitutes undistributed personal holding company income, which A and B must distribute to their shareholders to avoid personal holding company tax. Assume further that

A has an asset with a cost basis of $100 which is now worth $1,000, but that B has no such asset.

If A could distribute this asset and obtain a dividends-paid deduction of $1,000, it will have effectively shielded $900 of passive investment income from the personal holding company tax. On the other hand, B will be able to avoid the tax only if it distributes its entire undistributed personal holding company income of $1,000. As the court of appeals correctly observed, "[b]y basing the deduction for dividends paid on the amount of the corporation's investment in the property distributed, the regulation prevents any such income shielding" (Pet. App. A, p. 16; footnote omitted).

As the court of appeals further noted (Pet. App. A, pp. 16-17), the Regulations' adjusted basis rule is consistent with the taxable base that the 1954 Code prescribes for the personal holding company tax. In general terms, the taxable base for that tax (*i.e.*, "undistributed personal holding income") consists of the company's realized ordinary income increased by certain realized, but nontaxable income items (*e.g.*, dividends received from other corporations qualifying for the dividends-received deduction of Section 243 (see Section 545(b)(3)), and then decreased by certain actual expenses that are not recognizable for tax purposes (*e.g.*, federal income taxes and certain charitable deductions (Section 545(b)(1) and (2)). In other words, the taxable base consists of realized income, adjusted for actual expenses and distributions and certain nontaxable receipts.

The Regulation's adjusted basis rule, allowing a dividends-paid deduction for non-cash distributions only to the extent of basis, reflects this emphasis on realized income and expense items. In the normal case, a corporation's tax basis in property will equal the amount of realized, after-tax income invested in the property. Tying the deduction to basis ties it to the realized income the corporation is actually distributing.

Moreover, the Regulation is consistent with the rule Congress enacted in Section 312 of the 1954 Code. That section defines the extent to which a distribution in kind operates as a distribution "out of" a corporation's earnings and profits. Only to the extent that the distribution derives from the corporation's earnings and profits does it constitute a dividend taxable as such to the shareholders. Sections 316, 301.

A corporation does not realize taxable gain when it distributes appreciated property to its shareholders. See *General Utilities & Operating Co.* v. *Helvering*, 296 U.S. 200. See also Section 311(a) of the Code; S. Rep. No. 1622, 83d Cong., 2d Sess. 46, 247 (1954). A corporation likewise does not receive any income tax deduction for distributions of dividends.

But under the Code, a dividend distribution has an impact upon earnings and profits. A cash dividend distribution reduces the amount of earnings and profits on a dollar-for-dollar basis. See Section 312(a)(1). While the effect of a non-cash dividend distribution upon taxable earnings and profits was not

statutorily defined prior to the 1954 Code (see *Commissioner* v. *Hirshon Trust*, 213 F.2d 523 (C.A. 2), certiorari denied, 348 U.S. 861; *Commissioner* v. *Godley's Estate*, 213 F.2d 529 (C.A. 3), certiorari denied, 348 U.S. 862), Section 312(a)(3) of the 1954 Code provides that a non-cash distribution will reduce earnings and profits only to the extent of the corporation's cost basis in the distributed property. The reduction of corporate earnings and profits in the case of a dividend distribution is analogous to the deduction allowed from undistributed personal holding company income with respect to dividends paid by such corporations. The basis-limitation rule of the Commissioner's Regulation thus conforms to the treatment of earnings and profits in Section 312(a)(3).[18]

[18] In this respect, the Regulation departs from the rule of Section 27(d) of the 1939 Code, which had provided for a dividends-paid deduction for distributed property equal to its basis or fair market value, whichever was less. Under the Regulation, the deduction is always equal to the basis of the distributed property. Thus, if a corporation distributes property, the value of which has declined in its hands, it will be able to claim a deduction equal to its greater basis in the property.

Since the Regulation permits a personal holding company to distribute property whose value has declined and claim a deduction equal to its greater cost basis in such property, petitioners argue (Br. 27-29) that the Regulation is contrary to the statutory purpose of compelling distributions of all personal holding company income. As we have pointed out, there is a reference to "section 312" in the Senate Committee Report discussing Section 562 of the 1954 Code (see pp. 22-23, *supra*). The modification of the rule of Section 27(d) of the 1939 Code thus conforms the analogous dividends-paid deduction to the basis rule of Section 312(a)(3). There is accordingly support

C. Section 301(b) Does Not Support The Fair Market Rule For The Dividends-Paid Deduction Urged By Petitioners

1. Petitioners do not dispute that Section 27(d) of the 1939 Code explicitly provided that the dividends-paid deduction for non-cash distributions should equal the corporation's basis in the distributed property. They also do not challenge the fact that Sections 561 and 562 of the 1954 Code do not address the question of non-cash distributions. Section 561 merely lists the types of distributions that qualify for the deduction; Section 562 provides that to be eligible for the deduction, a distribution must fall within the defi-

in the legislative history as well as in Section 312 of the 1954 Code for the Commissioner's Regulation fixing basis as the uniform measure of the dividends-paid deduction.

General Securities Co. v. *Commissioner*, 42 B.T.A. 754, affirmed, 123 F.2d 192 (C.A. 10), upon which petitioners rely (Br. 28-29), does not support their position. There, the Board of Tax Appeals held that a personal holding company was entitled to a dividends-paid deduction under the Revenue Act of 1934 only to the extent of the fair market value of property that had declined in value while owned by the company. Although the statute at issue there (the 1934 Act) did not provide a specific measure for the deduction (see p. 18, *supra*), the Board reasoned that the deduction should be so limited because the shareholders were only taxable on the lesser value of the distributed property (see 42 B.T.A. at 758). But in enacting the Revenue Act of 1936, Congress necessarily rejected the *General Securities Co.* rationale, because that provision adopted different measures for determining the dividends-paid deduction and shareholder income (see pp. 19-20, *supra*). Accordingly, since *General Securities Co.* involved only the 1934 Act, and since the decision in that case is contrary to the dividends-paid credit statutes the Congress repeatedly has enacted since 1936, *General Securities Co.* is no longer an authoritative precedent.

nition of "dividend" set forth in Section 316. But Section 316 specifies only the source of payment out of which a corporation must make a distribution in order to meet the definition of a dividend. Petitioners therefore acknowledge (Br. 18) that it "provides no rule of valuation."

However, petitioners argue (Br. 13-18) that Section 316 must be read together with Section 301(b). The latter provision states that the amount of a corporate distribution that a non-corporate recipient must include in income is "the amount of money received, plus the fair market value of the other property received." In petitioners' view, the combined reading of Sections 301, 316, and 562 establishes that the Code requires that the amount of the dividends-paid deduction be equal to the amount that the recipient shareholder must include in his income.

We agree that Sections 301 and 316 must be read together to determine the tax consequences of a distribution at the shareholder level. See 1 Mertens, *Law of Federal Income Taxation* § 9.55 (1974 rev.). But it does not follow that these two provisions must be read together to determine the dividends-paid deduction at the corporate level. To the contrary, petitioners have not shown that Congress intended that the amount of a distribution for shareholder tax purposes, governed by Section 301(b), should also govern the dividends-paid deduction permitted to the corporation. As Judge Tannenwald observed for a majority of the Tax Court in *C. Blake McDowell, Inc.* v. *Commissioner, supra*, 67 T.C. at 1051,[19] in rejecting a similar contention:

> We are unimpressed by the argument, essentially grounded on policy considerations, that so long as the distributee is taxed on the full value of the distribution, the distributing corporation should be allowed a deduction for the same amount. The argument was available prior to 1954 and yet for more than a decade Congress saw fit to measure the deduction in terms of the distributing corporation's investment rather than the distributee's taxable receipt. Indeed, there is a discernible rationale that this was done to effectuate a countervailing policy of taxing or forcing distribution of *income* rather than unrealized appreciation. [Emphasis in original.]

Moreover, nothing in the language of Sections 301 (b), 316, or 562 suggests that the former provision should come into play in determining the amount of the corporate dividends-paid deduction. Indeed, the legislative history of Section 301 states unambiguously that it was intended to prescribe the tax consequences of distributions *at the shareholder level*. S. Rep. No. 1622, *supra*, at 231; H.R. Rep. No. 1337, *supra*, at A70. There is accordingly no basis to petitioners' argument that Section 301(b) prescribes a

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[19] Despite its view that the Regulation was valid, the Tax Court in *C. Blake McDowell, Inc.* held for the taxpayer because of its *Golsen* rule that it follows the decision of the circuit (*H. Wetter Manufacturing Co.* v. *United States, supra*) to which the case would be appealed. See *Golsen* v. *Commissioner*, 54 T.C. 742, affirmed on the substantive issue, 445 F.2d 985 (C.A. 10), certiorari denied, 404 U.S. 940.

fair market value measure of the dividends-paid deduction for non-cash distributions.

Finally, as the court of appeals properly observed (Pet. App. A, p. 15), Section 301(b) is not practically suited to the role petitioners seek for it. If Section 301(b) were to determine the amount of the dividends-paid deduction for a non-cash distribution in kind, the amount of a personal holding company's deduction would vary according to whether its shareholders were corporations or individuals. Under Section 301(b)(1)(A), distributions to non-corporate distributees are measured by the fair market value of the property distributed. Section 301(b)(1)(B), on the other hand, requires corporate distributees to report only the lesser of the fair market value or the distributor corporation's adjusted basis in the distributed property as the "amount" distributed.

While petitioners assert (Br. 11-12) that there is nothing anomalous in varying the dividends-paid deduction in accordance with the character of the recipient, they suggest no reason why the amount of the deduction should turn on such considerations. Indeed, the distinct income inclusion rules of Section 301 would require that a personal holding company with both corporate and non-corporate shareholders trace the distribution to its ultimate recipients in order to compute its dividends-paid deduction. In the absence of any legislative history supporting the proposition that Congress intended in 1954 to substitute such a complex system of measuring dividends paid for the uniform rule that had previously been in force for

almost 20 years, the court of appeals correctly rejected petitioners' reliance upon Section 301(b).[20]

H. Wetter Manufacturing Co. v. *United States*, *supra*, upon which petitioners rely (Br. 13, 22), was therefore incorrectly decided. There, the Sixth Circuit held that Sections 301, 316 and 562 unambiguously required that the dividends-paid deduction for non-cash distributions be equal to the fair market value of the distributed property. Although the court conceded that the legislative history of Section 562 supported the Commissioner's Regulation, it concluded that the "plain meaning" of Sections 301, 316 and 562 foreclosed reference to the legislative history (see 458 F.2d at 1034-1035).

But as we have pointed out *supra*, pp. 21-22, none of these provisions addresses the proper measure of the dividends-paid deductions. There is accordingly no basis for the Sixth Circuit's derogation of the clearly-stated legislative history in the face of the "plain meaning" of the statute, because the statute is completely silent on the question. Since the Commissioner's Regulation implements the intent of Congress by "filling the statutory gaps" and is in all re-

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[20] As the court of appeals observed (Pet. App. A, pp. 16-17), petitioners' rule leads to a further anomaly. Under that rule, two personal holding companies with identical amounts of undistributed income subject to the personal holding company tax and identical amounts invested in different corporate assets might be subject to different taxes after distributing those assets as dividends, because the assets had appreciated at different rates while in the companies' hands. The different taxes would be unrelated to the companies' disposition of the earnings subject to the tax.

spects consistent with the overall policy of the personal holding company tax to compel distributions, the decision below properly rejected the *H. Wetter Manufacturing Co.* rationale.

2. Petitioners' further reliance (Br. 18-21) upon *Ivan Allen Co.* v. *United States*, 422 U.S. 617, is likewise misplaced. There, the Court held that certain listed and readily marketable securities owned by the taxpayer corporation had to be taken into account at their net liquidation value for the purpose of determining whether it had permitted its earnings and profits to accumulate beyond the reasonable needs of its business within the meaning of Section 533(a) of the Code. Petitioners argue that because the Court in *Ivan Allen* ruled that the true economic value of corporate assets was a critical factor in the determination of the applicability of the accumulated earnings tax, the same measure should be used here in computing Pierce's liability for personal holding company taxes.

But petitioners' reading of *Ivan Allen* misses the point of that decision. As the Court there noted (422 U.S. at 627-628):

> It is important to emphasize that we are concerned here with a tax on "accumulated taxable income," § 531, and that the tax attaches only when a corporation has permitted "earnings and profits to accumulate instead of being divided or distributed," § 532(a). What is essential is that there be "income" and "earnings and profits." This at once eliminates, from the measure of the tax itself, any unrealized appreciation in the

> value of the taxpayer's portfolio securities over cost, for any such unrealized appreciation does not enter into the computation of the corporation's "income" and "earnings and profits."
>
> The corporation's readily marketable portfolio securities and their unrealized appreciation, nonetheless, are of profound importance in making the entirely discrete determination whether the corporation has permitted what, concededly, are earnings and profits to accumulate beyond its reasonable business needs. If the securities, as here, are readily available as liquid assets, then the recognized earnings and profits that have been accumulated may well have been unnecessarily accumulated, so far as the reasonable needs of the business are concerned. * * * In any event—and we repeat—the tax is directed at the accumulated taxable income and at earnings and profits. The tax itself is not directed at the unrealized appreciation of the liquid assets in the securities portfolio.

Thus, while the Court concluded that the net liquidation value of the securities must be considered in determining whether the taxpayer had unreasonably accumulated earnings, it emphasized that the unrealized appreciation in the securities was not includable in accumulated taxable income, the accumulated earnings tax base (see 422 U.S. at 627-628, 633, 634).

Here, on the other hand, there is no similar inquiry under the personal holding company tax that would take unrealized appreciation into account in determining whether a corporation is liable for the special tax. The personal holding company tax base is comprised entirely of realized items of income less actual dis-

bursements. See Section 545 of the Code. Thus, petitioners' fair market rule would distort the personal holding company tax base by permitting unrealized appreciation to serve as a deduction and thereby reduce the tax while not taking it into account on the income side. The Commissioner's Regulation is entirely consistent with the *Ivan Allen* rationale of excluding unrealized appreciation from the tax base.[21]

3. Finally, the fair market rule urged by petitioners is also contrary to other taxes that Congress has made subject to the dividends-paid deduction. In the tax treatment applicable to real estate investment trusts and regulated investment companies, Congress sought to permit groups of small investors to pool their funds and to obtain the investment advantages generally available to large investors, with only a minimum tax cost at the corporate level. But as a prerequisite to qualifying for these substantial tax benefits, Congress required the trusts and investment companies to distribute a high percentage of their ordinary income from investment activities as dividends to their investors each year. See Sections 852 and 857

[21] There are additional difficulties with petitioners' reliance on *Ivan Allen*. Thus, petitioners emphasize (Br. 20-21) that the dividends-paid deduction must equal fair market value so as to accord with the "economic reality" of a corporation's dividend in kind of appreciated property. But they do not explain how that assertion can be reconciled with their further assertion that Section 301(b) is to control the amount of a dividends-paid deduction, which would limit the deduction in situations involving corporate distributees to the lesser of adjusted basis or fair market value.

of the Code.[22] The dividends paid deduction provisions of Section 561, *et seq.* of the Code, including the Treasury Regulations directly in issue here, govern the determination whether this minimum distribution requirement has been met.

If these real estate investment trusts and regulated investment companies could measure the dividends-paid deduction for non-cash distributions by the fair market value of the property, it would be possible for them to satisfy the minimum distribution requirements by distributing appreciated assets representing actual earnings only to the extent of adjusted basis. The result would be that these entities would avoid tax treatment as corporations even though they would be retaining earnings just as any ordinary corporation. The rule we urge here, set forth in the Commissioner's Regulation, prevents this circumvention of the congressional design by allowing non-cash dividends to satisfy the minimum distribution requirement only to the extent of the basis of the distributed property. See Rev. Rul. 57-421, 1957-2 Cum. Bull. 367.

[22] See generally Sections 851-855 of the Code for provisions relating to regulated investment companies, and Sections 856-860 of the Code, as amended by the Tax Reform Act of 1976, Pub. L. 94-455, Sections 1601-1607, 90 Stat. 1742-1757, for the provisions concerning real estate investment trusts. See also H.R. Rep. No. 2020, 86th Cong., 2d Sess. (1960), and H.R. Rep. No. 2214, 86th Cong., 2d Sess. 8 (1960).

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

DANIEL M. FRIEDMAN,
*Acting Solicitor General.**

M. CARR FERGUSON,
Assistant Attorney General.

STUART A. SMITH,
Assistant to the Solicitor General.

MICHAEL L. PAUP,
JOSEPH L. LIEGL,
Attorneys.

OCTOBER 1977.

* The Solicitor General is disqualified in this case.

APPENDIX

Internal Revenue Code of 1954 (26 U.S.C. (1958 ed. and Supp. V)):

SEC. 301. DISTRIBUTION OF PROPERTY.

(a) *In General.*—Except as otherwise provided in this chapter, a distribution of property (as defined in section 317(a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c).

(b) *Amount Distributed.*—

(1) *General Rule.*—For purposes of this section, the amount of any distribution shall be—

(A) *Noncorporate Distributees.*—If the shareholder is not a corporation, the amount of money received, plus the fair market value of the other property received.

(B) [as amended by Sec. 13(f)(2), Revenue Act of 1962, 76 Stat. 1035] *Corporate Distributees.*—If the shareholder is a corporation, the amount of money received, plus whichever of the following is the lesser:

(i) the fair market value of the other property received; or

(ii) the adjusted basis (in the hands of the distributing corporation immediately before the dis-

tribution) of the other property received, increased in the amount of gain to the distributing corporation which is recognized under subsection (b) or (c) of section 311 or under section 1245(a).

* * * * *

(c) *Amount Taxable.*—In the case of a distribution to which subsection (a) applies—

(1) *Amount constituting dividend.*—That portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income.

* * * * *

(d) *Basis.*—The basis of property received in a distribution to which subsection (a) applies shall be—

(1) *Noncorporate distributees.*—If the shareholder is not a corporation, the fair market value of such property.

(2) [as amended by Sec. 13(f)(2), Revenue Act of 1962, 76 Stat. 1035] *Corporate distributees.*—If the shareholder is a corporation, whichever of the following is the lesser:

(A) the fair market value of such property; or

(B) the adjusted basis (in the hands of the distributing corporation immediately before the distribution) of such property, increased in the amount of gain to the distributing corporation which is recognized under subsection

(b) or (c) of section 311 or under section 1245(a).

* * * * *

SEC. 312. EFFECT ON EARNINGS AND PROFITS.

(a) *General Rule.*—Except as otherwise provided in this section, on the distribution of property by a corporation with respect to its stock, the earnings and profits of the corporation (to the extent thereof) shall be decreased by the sum of—

(1) the amount of money,

(2) the principal amount of the obligations of such corporation, and

(3) the adjusted basis of the other property, so distributed.

* * * * *

SEC. 316. DIVIDEND DEFINED.

(a) *General Rule.*—For purposes of this subtitle, the term "dividend" means any distribution of property made by a corporation to its shareholders—

(1) out of earnings and profits accumulated after February 28, 1913, or

(2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

(b) *Special Rules.*—

* * * * *

(2) *Distributions by personal holding companies.*—In the case of a corporation which—

(A) under the law applicable to the taxable year in which the distribution is made, is a personal holding company (as defined in section 542), or

(B) for the taxable year in respect of which the distribution is made under section 563(b) (relating to dividends paid after the close of the taxable year), or section 547 (relating to deficiency dividends), or the corresponding provisions of prior law, is a personal holding company under the law applicable to such taxable year,

the term "dividend" also means any distribution of property (whether or not a dividend as defined in subsection (a)) made by the corporation to its shareholders, to the extent of its undistributed personal holding company income (determined under section 545 without regard to distributions under this paragraph) for such year.

* * * * *

SEC. 541. IMPOSITION OF PERSONAL HOLDING COMPANY TAX.

In addition to other taxes imposed by this chapter, there is hereby imposed for each taxable year on the undistributed personal holding company income (as defined in section 545) of every personal holding company (as defined in section 542) a personal holding company tax equal to the sum of—

(1) 75 percent of the undistributed personal holding company income not in excess of $2,000, plus

(2) 85 percent of the undistributed personal holding company income in excess of $2,000.

SEC. 542. DEFINITION OF PERSONAL HOLDING COMPANY.

(a) *General Rule.*—For purposes of this subtitle, the term "personal holding company" means any corporation (other than a corporation described in subsection (c)) if—

(1) *Gross income requirement.*—At least 80 percent of its gross income for the taxable year is personal holding company income as defined in section 543, and

(2) *Stock ownership requirement.*—At any time during the last half of the tax-

able year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than 5 individuals. * * *

* * * * *

SEC. 545. UNDISTRIBUTED PERSONAL HOLDING COMPANY INCOME.

(a) *Definition.*—For purposes of this part, the term "undistributed personal holding company income" means the taxable income of a personal holding company adjusted in the manner provided in subsection (b), minus the dividends paid deduction as defined in section 561.

(b) *Adjustments to Taxable Income.*—For the purposes of subsection (a), the taxable income shall be adjusted as follows:

(1) [as amended by Sec. 9(d)(2), Revenue Act of 1962, 76 Stat. 1001] *Taxes.*—There shall be allowed as a deduction Federal income and excess profits taxes (other than the excess profits tax imposed by subchapter E of chapter 2 of the Internal Revenue Code of 1939 for taxable years beginning after December 31, 1940) and income, war profits and excess profits taxes of foreign countries and possessions of the United States (to the extent not allowable as a deduction under section 164(b)(6)), accrued during the taxable year or deemed to be paid by a domestic corporation under section 902(a)(1) or 960(a)(1)(C) for the taxable year, but not including the accumulated earnings tax imposed by section 531,

the personal holding company tax imposed by section 541, or the taxes imposed by corresponding sections of a prior income tax law. A taxpayer which, for each taxable year in which it was subject to the tax imposed by section 500 of the Internal Revenue Code of 1939, deducted Federal income and excess profits taxes when paid for the purpose of computing subchapter A net income under such Code, shall deduct taxes under this paragraph when paid, unless the taxpayer elects, in its return for a taxable year ending after June 30, 1954, to deduct the taxes described in this paragraph when accrued. Such an election shall be irrevocable and shall apply to the taxable year for which the election is made and to all subsequent years.

(2) [as amended by Sec. 32(a), Technical Amendments Act of 1958, 72 Stat. 1631] *Charitable contributions.*—The deduction for charitable contributions provided under section 170 shall be allowed, but in computing such deduction the limitations in section 170(b)(1)(A) and (B) shall apply, and section 170(b)(2) shall not apply. For purposes of this paragraph, the term "adjusted gross income" when used in section 170(b)(1) means the taxable income computed with the adjustments (other than the 5-percent limitation) provided in the first sentence of section 170(b)(2) and under paragraph (8) of this subsection.

(3) *Special deductions disallowed.*—The special deductions for corporations provided

in part VIII (except section 248) of subchapter B (section 241 and following, relating to the deduction for dividends received by corporations, etc.) shall not be allowed.

(4) [as amended by Sec. 32(b), Technical Amendments Act of 1958, 72 Stat. 1631] *Net operating loss.*—The net operating loss deduction provided in section 172 shall not be allowed, but there shall be allowed as a deduction the amount of the net operating loss (as defined in section 172(c)) for the preceding taxable year computed without the deductions provided in part VIII (except section 248) of subchapter B.

(5) *Long-term capital gains.*—There shall be allowed as a deduction the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year, minus the taxes imposed by this subtitle attributable to such excess. The taxes attributable to such excess shall be an amount equal to the difference between—

(A) the taxes imposed by this subtitle (except the tax imposed by this part) for such year, and

(B) such taxes computed for such year without including such excess in taxable income.

(6) *Bank affiliates.*—There shall be allowed the deduction described in section 601 (relating to bank affiliates).

(7) *Payment of indebtedness incurred prior to January 1, 1934.*—There shall be allowed as a deduction amounts used or irrevocably set aside to pay or to retire indebtedness of any kind incurred before January 1, 1934, if such amounts are reasonable with reference to the size and terms of such indebtedness.

(8) *Expenses and depreciation applicable to property of the taxpayer.*—The aggregate of the deductions allowed under section 162 (relating to trade or business expenses) and section 167 (relating to depreciation), which are allocable to the operation and maintenance of property owned or operated by the corporation, shall be allowed only in an amount equal to the rent or other compensation received for the use of, or the right to use, the property, unless it is established (under regulations prescribed by the Secretary or his delegate) to the satisfication of the Secretary or his delegate—

(A) that the rent or other compensation received was the highest obtainable, or, if none was received, that none was obtainable;

(B) that the property was held in the course of a business carried on bona fide for profit; and

(C) either that there was reasonable expectation that the operation of the property would result in a profit, or that the property was necessary to the conduct of the business.

(9) *Amount of a lien in favor of the United States.*—There shall be allowed as a deduction the amount, not to exceed the taxable income of the taxpayer, of any lien in favor of the United States (notice of which has been filed as provided in section 6323(a)(1), (2), or (3)) to which the taxpayer is subject at the close of the taxable year. The sum of the amounts deducted under this paragraph with respect to any lien shall, for the purposes of this section, be added to the taxable income of the taxpayer for the taxable year in which such lien is satisfied or released. Where an amount is added to the taxable income of a corporation by reason of the preceding sentence of this paragraph, the shareholders of the corporation may, pursuant to regulations prescribed by the Secretary or his delegate, elect to compute the income tax with respect to such dividends as are attributable to such amount as though they were received ratably over the period the lien was in effect.

(10) [as added by Sec. 3(d), Act of February 2, 1962, 76 Stat. 7] *Distributions of divested stock.*—There shall be allowed as a deduction the amount of any income attributable to the receipt of a distribution of divested stock (as defined in subsection (e) of section 1111), minus the taxes imposed by this subtitle attributable to such receipt, but only if the stock with respect to which the distribution is made was owned by the distributee on September 6, 1961, or

was owned by the distributee for at least 2 years prior to the date on which the antitrust order (as defined in subsection (d) of section 1111) was entered.

(11) [as added by Sec. 3(d), Act of February 2, 1962, 76 Stat. 7] *Special adjustment on disposition of antitrust stock received as a dividend.*—If—

(A) a corporation received antitrust stock (as defined in section 301(f)) in a distribution to which section 301 applied,

(B) the amount of the distribution determined under section 301(f)(2) exceeded the basis of the stock determined under section 301(f)(3), and

(C) Paragraph (10) did not apply in respect of such distribution,

then proper adjustment shall be made, under regulations prescribed by the Secretary or his delegate, if such stock (or other property the basis of which is determined by reference to the basis of such stock) is sold or exchanged.

SEC. 547. DEDUCTION FOR DEFICIENCY DIVIDENDS.

(a) *General Rule.*—If a determination (as defined in subsection (c)) with respect to a taxpayer establishes liability for personal holding company tax imposed by section 541 (or by a corresponding provision of a prior income tax law) for any taxable year, a deduction shall be allowed to the taxpayer for the amount of de-

ficiency dividends (as defined in subsection (d)) for the purpose of determining the personal holding company tax for such year, but not for the purpose of determining interest, additional amounts, or assessable penalties computed with respect to such personal holding company tax.

* * * * *

(c) *Determination.*—For purposes of this section, the term "determination" means—

(1) a decision by the Tax Court or a judgment, decree, or other order by any court of competent jurisdiction, which has become final;

(2) a closing agreement made under section 7121; or

(3) under regulations prescribed by the Secretary or his delegate, an agreement signed by the Secretary or his delegate and by, or on behalf of, the taxpayer relating to the liability of such taxpayer for personal holding company tax.

(d) *Deficiency Dividends.*—

(1) *Definition.*—For purposes of this section, the term "deficiency dividends" means the amount of the dividends paid by the corporation on or after the date of the determination and before filing claim under subsection (e), which would have been includible in the computation of the deduction for dividends paid under section 561 for the taxable year with respect to which the liability for personal holding company tax exists, if distributed during such taxable year. No dividends shall be considered as deficiency dividends for purposes of subsection (a) unless distributed within 90 days after the determination.

* * * * *

SEC. 561. DEFINITION OF DEDUCTION FOR DIVIDENDS PAID.

(a) *General Rule.*—The deduction for dividends paid shall be the sum of—

(1) the dividends paid during the taxable year,

(2) the consent dividends for the taxable year (determined under section 565), and

(3) in the case of a personal holding company, the dividend carryover described in section 564.

(b) [as amended by Sec. 3(f), Act of February 2, 1962, 76 Stat. 8] *Special Rules Applicable.*—

(1) In determining the deduction for dividends paid, the rules provided in section 562 (relating to rules applicable in determining dividends eligible for dividends paid deduction) and section 563 (relating to dividends paid after the close of the taxable year) shall be applicable.

* * * * *

SEC. 562. RULES APPLICABLE IN DETERMINING DIVIDENDS ELIGIBLE FOR DIVIDENDS PAID DEDUCTION.

(a) *General Rule.*—For purposes of this part, the term "dividend" shall, except as otherwise provided in this section, include only dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions).

* * * * *

Treasury Regulations on Income Tax (1954 Code) (26 C.F.R.):

§ 1.562-1 *Dividends for which the dividends paid deductions is allowable*

(a) *General rule.* Except as otherwise provided in section 562(b) and (d), the term "dividend", for purposes of determining dividends eligible for the dividends paid deduction, refers only to a dividend described in section 316 (relating to definition of dividends for purposes of corporate distributions). No distribution, however, which is preferential within the meaning of section 562(c) and § 1.562-2 shall be eligible for the dividends paid deduction. Moreover, when computing the dividends paid deduction with respect to a United States person (as defined in section 957(d)), no distribution which is excluded from the gross income of a foreign corporation under section 959(b) with respect to such person or from the gross income of such person under section 959(a) shall be eligible for such deduction. Further, for purposes of the

dividends paid deduction, the term "dividend" does not include a distribution in liquidation unless the distribution is treated as a dividend under section 316(b)(2) and paragraph (b)(2) of § 1.316-1, or under section 333(e)(1) and paragraph (c) of § 1.333-4 or paragraph (c)(2), (d)(1)(ii), or (d)(2) of § 1.333-5, or qualifies under section 562(b) and paragraph (b) of this section. If a dividend is paid in property (other than money) the amount of the dividends paid deduction with respect to such property shall be the adjusted basis of the property in the hands of the distributing corporation at the time of the distribution. See paragraph (b)(2) of this section for special rules with respect to liquidating distributions by personal holding companies occurring during a taxable year of the distributing corporation beginning after December 31, 1963. Also see section 563 for special rules with respect to dividends paid after the close of the taxable year.

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☆ U. S. GOVERNMENT PRINTING OFFICE: 1977 247348 69

Supreme Court, U. S.
FILED
NOV 23 1977
MICHAEL RODAK, JR., CLERK

In the Supreme Court of the United States

OCTOBER TERM, 1977

No. 76-1137

ARTHUR FULMAN, Et Al, TRUSTEES,
PETITIONERS,

v.

UNITED STATES OF AMERICA,
RESPONDENT.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIRST CIRCUIT

REPLY BRIEF ON BEHALF OF PETITIONER

DANIEL D. LEVENSON
LESLIE CRANE SLAVIN
One State Street
Boston, Massachusetts 02109
(617) 742-6720
Attorneys for Petitioners

Of Counsel:
LOUBIE & CUTLER
One State Street
Boston, Mass. 02109

Blanchard Press, Inc., Boston, Mass. — Law Printers

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REPLY BRIEF ON BEHALF OF PETITIONER

This Reply Brief is being filed to rebut (1) the Government's characterization of the purpose of the personal holding company tax and (2) the Government's unsupportable conclusion that Treas. Reg. 1.562-1(a) is justified by legislative history.

I. The Government Distorts the Purpose of the Personal Holding Company and Accumulated Earnings Taxes.

In constructing its justification of Treas. Reg. §1.562-1(a), the Government has exhibited a serious misconception of the role and purpose of the personal holding company tax. It thus sees tax avoidance where none exists, turns logically related principles into inconsistencies and defends a rule which is inconsistent with the real purpose of the statute.

As Petitioner has shown in its brief, the object of the personal holding company tax, and not incidentally, the accumulated earnings tax, is to insure taxation at the shareholder level of amounts equal to a corporation's net personal holding company income or accumulated taxable income. (P. Br. 8-13) The means by which this object is accomplished is the imposition of an additional tax upon corporations which will induce the distribution of *an amount equal to* net personal holding company income (or accumulated taxable income) to shareholders as dividends. By focusing upon the consequences of the personal holding company tax on the corporate entity and ignoring its consequences at the shareholder level, the Government has grossly distorted the purpose of the taxes.

Drawing its conclusions from this distorted point of view, the Government contends that under Petitioner's proposed rule, a corporation would be improperly avoiding the personal holding company tax if it retained income which had derived from passive investment sources, even though it had distributed enough property to its shareholders to result in their being taxed upon an amount equal to the corporation's net personal holding company income. (G. Br. 6, 15, 29). Although the objective of the tax would be completely satisfied if the shareholders to

whom the property were distributed included the fair market value of the property in their income and paid tax on the full amount of the company's net personal holding company income, the Government implies that a tax is being avoided if the dividends distributed cannot be directly traced to the current year's passive investment income.[1] Not only does this perspective ignore the economic realities of business life and the ebb and flow of cash, assets and profits, but it ignores both the operation of Subchapter C of the Internal Revenue Code and the fact that nothing in the law mandates a distribution of currently earned income.

The law permits, indeed, is designed to encourage a corporation to avoid the personal holding company tax or the accumulated earnings tax by distributing *an amount equal to* its net personal holding company income or accumulated taxable income. It is unimportant and irrelevant which assets are distributed or from what source the dividend distribution derives. All that is important and relevant is that the recipient shareholder be required, as a result of the distribution, to include in gross income an amount equal to the company's net personal holding company or accumulated taxable income.

Under section 316, and therefore under section 562, the source of corporate property is irrelevant to the deter-

---

[1] The government apparently visualizes a personal holding company as having some special bank account into which it deposits dividend checks received and all other income realized from passive investments, and that unless the company draws on that particular account for the dividend checks distributed to its shareholders, it is not distributing the "earnings realized" from its passive investments. Actually the personal holding company might immediately reinvest all of such income in other assets, and yet be in a position to make distributions "to the extent of its undistributed personal holding company income" (section 316(b)(2)), by borrowing the needed amount, by selling non-investment assets, or by distributing any property, however acquired. It does not matter that the very dollars of income realized by the personal holding company are not traceable directly into the dividends it distributes.

mination of whether its distribution will constitute a dividend. This is so even if the corporation has not invested any of its realized earnings in the distributed property. It must be remembered that a corporation may obtain property not only through purchase, but also as a contribution to capital, in exchange for stock, in a tax-free reorganization, as an inter-corporate dividend or as the result of the divestiture of anti-trust stock. But, for purposes of section 316, these distinctions are irrelevant. Distribution of any property, regardless of how it was obtained, will be a dividend within the meaning of section 316, and thus of section 562, as long as there are "earnings and profits" or personal holding company income to satisfy the requirements of section 316(a) or 316 (b)(2). Under section 316(a) a distribution is conclusively presumed to come "out of" any earnings and profits a corporation may have. This presumption makes it impossible to earmark a particular distribution as coming "out of" some other source, such as "paid-in surplus" or "depreciation reserves" or "unrealized appreciation." See Mertens, *Law of Federal Income Taxation* (1974 revision) Section 9.27, citing *inter alia, Beretta* v. *Commissioner*, 141 F.2d 452 (5th Cir. 1944), *aff'g* 1 T.C. 86 (1942), *cert. denied*, 323 U.S. 720. Instead, if the amount of a corporation's earnings and profits equals or exceeds the amount of a distribution to shareholders, as measured under section 301, such amount will automatically be "a dividend (as defined in section 316)" which is required by section 301(c) to be included in the shareholder's gross income.[3]

[3] The close interrelationship between sections 301 and 316 is illustrated by the Regulations promulgated under section 316. Treas. Reg. §1.316-1(a)(3) contains the following example of the determination of the amount of a dividend:

> "Example. X and Y, individuals, each own one-half of the stock of Corporation A which has earnings and profits of $10,000. Corporation A distributes property having a basis of $6,000 and a fair market value of $16,000 to its shareholders, each shareholder receiving property with a basis of $3,000 and with a fair market value of $8,000 in a distribution to which section 301 applies. The amount taxable to each shareholder as a dividend under section 301(c) is $5,000."

The adjusted basis of the property distributed is thus irrelevant to the determination of the amount of the dividend under 316, even though under section 312, the corporation's earnings and profits would be reduced by the corporation's adjusted basis in the property. In fact, even the Regulations under section 312 differentiate between the adjustment to earnings and profits and the amount of a dividend. Treas. Reg. §1.312-1(c) contains the following two examples:

> "Example (1). Corporation A distributes to its sole shareholder property with a value of $10,000 and a basis of $5,000. It has $12,500 in earnings and profits. The reduction in earnings and profits by reason of such distribution is $5,000. Such is the reduction even though the amount of $10,000 is includible in the income of the shareholder (other than a corporation) as a dividend.
>
> Example (2). The facts are the same as in example (1) above except that the property has a basis of $15,000 and the earnings and profits of the corporation are $20,000. The reduction in earnings and profits is $15,000. Such is the reduction even though only the amount of $10,000 is includible in the income of the shareholder as a dividend."

Furthermore, the Government's position is flawed by a basic factual inaccuracy. A corporation's basis in its property does not necessarily equal the cost of that property (G. Br. 31), nor is it necessarily tied to the company's realized earnings (G. Br. 29). These claims made by the Government to support its "adjusted basis rule" ignore both the fact that property is acquired by corporations by means other than purchase, and that the Code permits taxpayers to make several adjustments to the cost basis of property. For example, a corporation may depreciate certain properties and may elect among several methods or rates of depreciation. If depreciable property were distributed by two corporations, each of which invested the same amount in the property, but each of which depreciated the property at a different rate, then the application of Treas. Reg. §1.562-1(a) would result in a different deduction for

each corporation even if the fair market value of both pieces of property were identical.

In focusing upon the means by which the personal holding company tax and the accumulated earnings tax operate, the Government has lost sight of their common objectives. It must be remembered that

> [T]he real objective of the tax is to create a tax at the shareholder level equal to the corporation's earnings for the year. The objective, by definition, is satisfied only if the corporation's deductions for dividends paid is equal to the dividends taxable to its shareholders. Accordingly, the objective is satisfied, not frustrated, when individual shareholders, pursuant to sections 301 and 316, report dividends equal to the fair market value of the property distributed in kind and the corporation gets a deduction in the same amount for dividends paid. The fact that the fair market value of the property is greater or less than its adjusted basis is not relevant in determining whether the objective has been satisfied. Drake, *Distributions in Kind and the Dividends Paid Deduction—Conflict in the Circuits*, 1977-1 BRIGHAM YOUNG U.L. REV. 45, 68.[3]

II. LEGISLATIVE HISTORY OFFERS NO SUPPORT FOR TREASURY REGULATION §1.562-1(a).

The Government concludes from its study of the legislative history of the 1954 Code that (a) Congress intended

[3] This article, which contains a very thorough discussion of the issue involved in this case, came to the attention of Petitioner subsequent to the filing of its main brief. In addition, two other articles dealing with the regulation at issue have been published since the Petitioner's brief was filed. They are Zuccarini, *On Appeal to the Supreme Court in Fulman: Property Distributions by Personal Holding Companies''*, 55 *Taxes* 715 (Nov. 1977), and Axelrod, *The Accumulated Earnings Tax and the Deduction for Dividends in Property – Market Value or Basis?''* 4 JOURNAL OF CORPORATE TAXATION 208 (Autumn, 1977).

to preserve the rule of section 27(d) of the 1939 Code, which permitted a corporation making a non-cash distribution a deduction equal to the *lesser* of the property's *fair market value* or *basis*, (G. Br. 22) and (b) that Treas. Reg. §1.562-1(a) perpetuates the rule of section 27(d). (G. Br. 26-7) The first conclusion is unfounded. The second is simply a factual mistatement.

The Government's interpretation of Congressional intent is based upon the following section of the Senate Committee Report discussing section 562 of the present Code:

> Subsection (a) provides that the term ''dividend'' for purposes of this part shall include, except as otherwise provided in this section, only those dividends described in section 316 (relating to definition of dividends for purposes of corporate distributions). The requirements of section 27(d), (e), (f), and (i) of existing law are contained in the definition of ''dividend'' in section 312,[4] and accordingly are not restated in section 562. S. Rep. No. 1622, 83d Cong., 2d Sess. 325 (1954).

Despite the language of the Report, the rules of section 27(d), (e), (f) and (i) simply are not stated in section 312 of the House Bill, section 316 of the Senate Bill or section 316 of the Code as adopted. To conclude, as does the Government, that this Committee Report indicates explicit Congressional intent to carry forward the provisions of section 27(d) is totally unsupportable. The Government's

[4] As has been noted by the District Court in this case (Pet. App. B, 22, n.5) as well as by numerous commentators (e.g. Drake, *supra* at 59; Axelrod, *supra* at 22-23; Zuccarini, *supra* at 716), this reference to section 312 is an obvious typographical error deriving from the renumbering of the House Bill by the Senate. This point has been so universally accepted that it was felt that it was unnecessary to reconstruct the complicated and involved historical proof of this point. However, should the Court feel it necessary, Petitioner is ready to submit a supplemental brief confined to this point.

position is counter-indicated by the time and care devoted by Congress and the committee staffs to the drafting of the 1954 Code. This was not a hastily drafted statute. It was considered over a three year period, and significant attention was paid to the problems of the corporate-shareholder relationship. Had Congress meant to include rules of section 27 in the Code, it would have done so specifically.

The more reasonable interpretation of the language in the Committee Reports, as explained by Petitioner in its brief (P. Br. 24), has been adopted by at least one commentator:

> As an alternative to the conclusion of the *Fulman* courts, one can reasonably argue that the term "requirements" in the second sentence of the statement suggests that the drafters of the reports merely intended that this sentence communicate to the reader that the functions or "requirements" previously satisfied by sections 27(d), (e), (f), and (i) of the 1939 Code are now satisfied by section 316 of the 1954 Code. In other words, the second sentence of the statement was not intended to indicate that section 316 of the 1954 Code incorporates the exact rules of section 27 of the 1939 Code, but rather that the term "dividend" as defined in section 316 of the 1954 Code, eliminates the need for the old rules. Drake, *supra* at 61.

This interpretation is not rendered less persuasive by the principles of statutory construction cited by the Government. While the rule of *United States* v. *Ryder*, 110 U.S. 729 may be a "longstanding canon of statutory construction" (G. Br. 26), it is not applicable in this case. The statute construed in *Ryder* was "taken from and [was] substantially a reproduction of" a prior statute dealing with

the same subject matter. 110 U.S. at 738. In contrast, the 1954 Code was a thorough revision of existing revenue statutes; it was not a mere consolidation of the law or a minor change in language. Congress did not, in 1954, confine itself to "substitution of plain language for awkward terms, reconciliation of conflicting laws, omission of superceded sections and consolidation of similar provisions." *Muniz* v. *Hoffman*, 422 U.S. 454, 469. With respect to section 27 of the 1939 Code, Congress did not simply make a modification in its language. The section was eliminated. Petitioner is not inferring the repeal of section 27(d) by implication.[5] (G. Br. 26). Petitioner is noting its repeal by elimination.

Furthermore, and of utmost importance, the Government has unaccountably failed to perceive the very obvious difference between the rule of old section 27(d) and Treas. Reg. §1.562-1(a). As described previously, the rule of section 27(d) provided that the dividends-paid deduction would equal the *lesser* of the fair market value or the adjusted basis of property distributed. "Yet the regulations use adjusted basis regardless of fair market value—a rule which few would argue is not considerably different from that described in section 27(d)." TAXES, *supra*, note 3 at 717.

While it is true that if a deduction is equal to the lesser of adjusted basis or fair market value, it can never exceed adjusted basis, this observation is incomplete. Under such a rule the deduction can also never exceed the property's fair market value. Thus, fair market value as well as basis serves as the upper limit for the deduction. Because

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[5] We are not dealing with the question of whether two intersecting statutes can co-exist. Thus, none of the cases cited by the government on this point, *Regional Rail Reorganization Act Cases*, 419 U.S. 102; *Mercantile National Bank* v. *Langdeau*, 371 U.S. 555; *United States* v. *Borden Co.*, 308 U.S. 188; *Amell* v. *United States*, 384 U.S. 158, are relevant.

section 27(d) defined the deduction as the *lower* of two amounts, both figures are actually an upper limit for the deduction. The rule of section 27(d) is just as similar to the rule advocated by Petitioner as it is to Treas. Reg. §1.562-1(a). The Government's claim that the rule of section 27(d), was the "very rule that is incorporated in the Commissioner's present Regulation" (G. Br. 19) is simply untenable.

Contrary to the Government's assertion, section 27(d) did *not* provide that "the dividends paid deduction for non-cash distributions should equal the corporation's basis in the distributed property." (G. Br. 33). The impression created by the Government's brief that Treas. Reg. §1.562-1(a) merely restates a long-standing "adjusted basis rule" is thus without merit, and legislative history cannot be used to support the validity of Treas. Reg. §1.562-1(a).

Finally, the Government has ignored one important feature of the legislative history that affirmatively supports Petitioner's position. This feature is discussed in Petitioner's original brief, beginning on page 13, where we point to the definition of the term "dividend" in the House draft of the bill which became the Internal Revenue Code of 1954. The successive drafts of that bill indicate affirmatively that Congress intended to make the valuation rules of section 301 applicable in determining the amount of a "dividend" as defined in section 316 of the Code, which section 562 in turn makes eligible for inclusion in the dividends paid deduction.

The Government's brief avoids any reference to the House draft of the bill and does not attempt to answer the argument based on pages 13-18 of Petitioner's brief.

Conclusion

For the reasons stated above and in its original Brief on the merits, Petitioner submits that the judgment below should be reversed.

Respectfully submitted,

DANIEL D. LEVENSON
LESLIE CRANE SLAVIN
(617) 742-6720
One State Street
Boston, Massachusetts 02109
Attorneys for Petitioners

Of Counsel:
LOURIE & CUTLER
One State Street
Boston, Mass. 02109